# Uniform certified public accountant examinations, May 1960 to November 1962; Uniform CPA examination questions, May 1960 to November 1962 

American Institute of Certified Public Accountants. Board of Examiners

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## UNIFORM CPA EXAMINATION QUESTIONS

# 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.

MAY 1960 to NOVEMBER 1962

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## FOREWORD

This volume, the twelfth of its kind, includes 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. The examinations from May 1960 to November 1962, inclusive, are included in this volume. The eleven prior volumes contain all the examinations since 1917.

While the American Institute of Certified Public Accountants does not publish official answers, it is felt that students may be benefited by a review of the unofficial answers published twice a year as a supplement to The Journal or Accountancy. Consequently, we are publishing simultaneously with this volume, a companion book entitled Unofficial Answers to the Uniform CPA Examinations, May 1960 to November 1962, which contains answers to the questions included in this volume.

John L. Carey, Executive Director
American Institute of Certified Public Accountants
April 1963

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## Examination, May, 1960

# EXAMINATION IN ACCOUNTING PRACTICE-PART I <br> May 18, 1960; 1:30 p.m. to 6:00 p.m. 

## GROUP I

Solve all problems in this group.

## Number 1 (Estimated time- 25 to 35 minutes)

Houston Factors, Inc., was incorporated December 31, 1959. The capital stock of the company consists of 100,000 shares of $\$ 10$ par value each, all of which was paid in at par. The company was organized for the purpose of factoring the accounts receivable of various businesses requiring this service.

Houston Factors, Inc. charges a commission to its clients of 2 per cent of all receivables factored and assumes all credit risks. Besides the commission, an additional 10 per cent of gross receivables is withheld on all purchases and is credited to Client Reserve. This reserve is used for merchandise returns, etc., made by customers of the clients for which a credit memo would be due. Payments are made to the clients by Houston Factors, Inc. at the end of each month to adjust the reserve so that it equals 10 per cent of the unpaid receivables as at the month's end.

Based on the collection experience of other factoring companies in this area, officials of Houston Factors, Inc. have decided to make monthly provisions to Allowance for Bad Debts based on one-fourth per cent of all receivables purchased during the month.

The company also decided to recognize commission income on only the factored receivables which have been collected; however, for bookkeeping simplicity all commissions are originally credited to Commission Income and an adjustment is made to Unearned Commissions at the end of each quarter based on 2 per cent of receivables then outstanding.

Operations of the company during the first quarter of 1960 resulted in the following:

Accounts receivable factored

| January | $\$ 200,000$ |
| :--- | ---: |
| February | 400,000 |
| March | 300,000 |

Collections on the above receivables totaled $\$ 700,000$.
General and administrative expenses paid during the period were as follows:
Salaries \$5,000

Office rent 900
Advertising 500
Equipment rent $\quad 1,600$
Miscellaneous 1,000
On February 1, 1960 a three-month 6 per cent bank loan was obtained for $\$ 500,000$, with interest payable at maturity.

For the first three months of the year, the company rented all of its office furniture and equipment; however, on March 31, 1960 it purchased various equipment at a cost of $\$ 5,000$, liability for which had not been recorded as of March 31.

## Required:

a. All entries necessary to record the above transactions and to close the books as at March 31, 1960. (Disregard all withholding taxes and the company liability for F.I.C.A. and federal income taxes.)
b. A balance sheet and an income statement for Houston Factors, Inc. as at March 31, 1960.

## Number 2 (Estimated time- 60 to 95 minutes)

The Rickard Company's fiscal year ended March 31, 1960. Your examination the preceding year disclosed that the internal control was weak. The staff and organization were unchanged.

The office manager was unable to reconcile the bank statements at March 31, and opened an account called "Exchange" for $\$ 170$ in order to balance his preliminary trial balance.

In your discussions with Mr. Rickard, the owner, you learned that receipts from cash sales were deposited only once a week, in the Central Bank. All disbursements were made by checks drawn on either the Central or State Bank. The checks were drawn upon either bank regardless of the type of expenditure.

Mr. Rickard also revealed that he attended a convention early in March and drew several checks (which have not been recorded) while entertaining prospective buyers.

You have available the following records of the client:

1. The cash receipts book for March 1960.
2. The cash disbursements book for March 1960.
3. The general ledger cash accounts.
4. The bank reconciliation of both bank accounts at February 29, 1960.
5. The bank statement and accompanying data for March from the Central Bank.
6. The bank statement and accompanying data for March from the State Bank.

As part of your confirmation procedure you requested and received directly:
7. A cut-off statement dated April 11, 1960 and accompanying data from the Central Bank.
8. A cut-off statement dated April 11, 1960 and accompanying data from the State Bank.

## Required:

a. Reconcile both bank balances to the adjusted cash balances as of March 31, 1960.
b. Prepare all necessary journal entries to adjust the cash accounts at March 31, 1960. (Assume that the books have not been closed.)
1.

Cash Receipts Book

| Date | Account Credited | $\underline{L F}$ | Amount | Accounts Receivable Credit | $C A S H$ |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  | Central Bank Debit | State Bank Debit |
| 1960 |  |  |  |  |  |  |
| March 1 | B. Hillman | $\checkmark$ |  | 686 |  | 686 |
| 2 | Notes receivable | 130 | 2,400 |  |  |  |
|  | Interest income | 813 | , 24 |  |  | 2,424 |
| 4 | Sales | 401 | 5,497 |  | 5,497 |  |
| 9 | M. Walker |  |  | 1,587 |  | 1,587 |
| 10 | Purchase allowances | 519 | 684 |  |  | 684 |
| 11 | B. Kline | $\checkmark$ |  | 770 |  | 770 |
| 11 | Sales | 401 | 6,533 |  | 6,533 |  |
| 14 | Notes receivable discounted | 131 | 2,000 |  |  | 2,000 |
| 18 | Sales | 401 | 1,629 |  | 1,629 |  |
| 23 | B. Mercedes | $\checkmark$ |  | 800 | 800 |  |
| 25 | Sales | 401 | 1,502 |  | 1,502 |  |
| 31 | W. Benson | $\checkmark$ |  | 713 |  | 713 |
|  |  |  | 20,269 | 4,556 | 16,061 | 8,864 |

2. 

Cash Disbursements Book

| Date | Account Debited | $\underline{L F}$ | Amount | Accounts Payable Debit | Check <br> No. | $C A S H$ |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  | Central Bank Credit | State Bank Credit |
| 1960 |  |  |  |  |  |  |  |
| March 2 | M. Moss | $\checkmark$ |  | 737 | 634 | 737 |  |
| 4 | Office supplies | 701 | 73 |  | 635 | 73 |  |
| 10 | Insurance | 707 | 217 |  | 1,080 | 217 |  |
| 10 | Note payable | 230 | 2,800 |  |  |  |  |
|  | Interest expense | 713 | 14 |  | 1,081 |  | 2,814 |
| 11 | Office furniture | 145 | 210 |  | 1,082 |  | 210 |
| 14 | Selling expense | 509 | 200 |  | 636 | 200 |  |
| 18 | Queen Co. | $\checkmark$ |  | 1,600 | 637 | 1,600 |  |
| 18 | O. Randolph Co. | $\checkmark$ |  | 2,156 | 638 | 2,156 |  |
| 23 | Contribution | 728 | 200 |  | 1,083 |  | 200 |
| 25 | Sales allowances | 403 | 17 |  | 1,084 |  | 17 |
| 28 | Salaries | 702 | 845 |  | 639 |  | 845 |
| 31 | A. Hansen \& Co. | $\checkmark$ |  | 363 | 640 | 363 |  |
| 31 | I. Marlon | $\checkmark$ |  | 612 | 1,085 |  | 612 |
|  |  |  | 4,576 | $\underline{5,468}$ |  | 5,346 | 4,698 |

3. 

General ledger-Cash accounts:
Cash-Central Bank

| $\begin{array}{ll} 1960 \\ \text { March } & 1 \\ 31 \end{array}$ | Balance | $\stackrel{V}{C R}$ | $\begin{array}{r} 5,843 \\ 16,061 \end{array}$ <br> Cash | 1960 <br> March 31 <br> Bank | CD | 5,346 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| $\begin{array}{ll} 1960 \\ \text { March } & 1 \\ 31 \end{array}$ | Balance | $\underset{C R}{V}$ | $\begin{array}{r} 733 \\ 8,864 \end{array}$ | $\begin{aligned} & 1960 \\ & \text { March } 31 \end{aligned}$ | CD | 4,968 |


6.

STATE BANK
Statement
Account: The Rickard Company

| Date | Charges |  | Deposits | Balance |
| :---: | :---: | :---: | :---: | :---: |
| 1960 |  |  |  |  |
| Feb. 29 |  |  |  | 3,237 |
| March 1 | 43 | 59 | 686 | 3,821 |
| 2 | 2,402 | 689DM | 2,424 | 3,154 |
| 9 |  |  | 1,587 | 4,741 |
| 11 | 2,814 | 4DM | 1,454 | 3,377 |
| 14 | 217DM |  | 2,000 | 5,160 |
| 18 | 220 |  | 686 | 5,626 |
| 25 | 17 |  | 1,900CM | 7,526 7,509 |

Cancelled checks returned with bank statement:

| No. 1062 | $\$ 2,402$ | No. 1081 | $\$ 2,814$ |
| ---: | ---: | ---: | ---: |
| 1074 | 43 | 1082 | 220 |
| 1079 | 59 | 1084 | 17 |

Debit memoranda enclosed with bank statement:
Service charge \$ 4
For certified check (No. 1080) ............................................... 217
Charge for an "insufficient funds" check of B. Hillman:
Face of check . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . \$686
Protest fee .............................................................. 3
689
This check was subsequently redeposited.
Credit memorandum included with bank statement:
For Mueller Co. non-interest bearing note entered for collection and subse-
quently collected
7. CENTRAL BANK

Statement
Account: The Rickard Company

| Date |  |  |  | Charges | Deposits |
| :--- | ---: | :--- | :--- | :--- | :--- |

Cancelled checks attached to bank statement:

No. 646 \$959
647
82
43

No. 650
\$167
651 55 Check written by Rickardy Company
8.

Account: The Rickard Company

| Date | Charges | $\underline{\text { Deposits }}$ | Balance |
| :---: | :---: | :---: | :---: |
| 1960 |  |  |  |
| March 31 |  |  | 7,509 |
| April 1 | 153 | 2,540 | 9,896 |
| 4 | 70 |  | 9,826 |
| 8 |  | 1,732 | 11,558 |
| 11 | 200 |  | 11,358 |

Cancelled checks returned with bank statement:
No. $1083 \quad \$ 200$
$1090 \quad 153$
70 Drawn by Mr. Rickard while at convention during March

## Number 3 (Estimated time- 30 to 45 minutes)

Dr. John Black, M.D., a general practitioner in Salt Lake City, Utah, asked you to prepare his 1959 federal income tax return and to use those benefits afforded under the law which will result in the lowest tax. Dr. Black, aged 35, and his wife who is 27 , have one son born on December 29, 1959. Mrs. Cary Dorga, the mother of Mrs. Black, aged 67, lives with the Blacks; she has no separate income.

In prior years Dr. Black has reported his income on a cash basis. Mrs. Black has no income other than that reported below. Pertinent data are summarized from Dr. Black's records as follows:
Income:
Professional receipts ..... \$20,000
Dividends received on capital stock:
Beneficial Mutual Life Insurance Co. (in husband's name) ..... 300
Union Pacific Railroad Co. (in wife's name) ..... 250
Dividend received on National Service Life Insurance Policy ..... 60
Dividends credited account with Federal Savings \& Loan ..... 120
Proceeds from four $\$ 100$, maturity value, Series E U.S. Savings Bonds, no portion reported in prior years ..... 380
Interest on Murray City Bonds ..... 50
Proceeds from sale of 1,000 shares of Canyon Uranium bought 2/28/59 for $\$ .50$ per share and sold $8 / 29 / 59$ for $\$ 1.50$ per share ..... 1,500
Advance royalties received on a non-productive oil and gas lease (no cost basis) ..... 1,000
Directors fees-XYZ Corporation ..... 400
Proceeds from sale of 1957 automobile (used $100 \%$ for business) pur- chased $3 / 1 / 57$ for $\$ 3,650$ and sold $6 / 21 / 59$. To date of sale $\$ 1,670$ in depreciation had been claimed ..... 1,850
Expenditures:
Wages paid receptionist ..... 4,000
Office rent ..... 1,000
Drugs and supplies ..... 3,985
Other professional expenses ..... 400
Depreciation on 1957 automobile ..... 340
Personal property tax (office property) ..... 15
1959 automobile purchased on $7 / 1 / 59$ (used $100 \%$ in business; useful life 5 years) ..... 3,750
Interest paid on home mortgage to Peoples Bank ..... 200
Contributions-Church ..... 100
Contributions-Community Chest ..... 50
Property taxes-home ..... 150
State sales taxes on personal expenditures ..... 50
Utah state income taxes ..... 100
Medical expenses:
Paid for Mrs. Black's mother-Doctors-\$70; Hospital-\$180 ..... 250
Paid for own family-Dentist-\$150 ..... 150
Payments made on 1959 Declaration of Estimated Federal Income Tax to Utah Director ..... 1,600

## Required:

Compute the amount of the 1959 taxable income, using appropriate schedules to disclose your analysis.

## Number 4 (Estimated time- 35 to 50 minutes)

You have been engaged to make an audit of the records of Flowers, Inc. for the year ended December 31, 1959. The records of the company have not been previously audited. The following is a summary trial balance as of December 31, 1959:

| Current assets | \$567,750 |  |
| :---: | :---: | :---: |
| Real estate | 304,500 |  |
| Allowance for depreciation |  | \$ 90,660 |
| Current liabilities |  | 137,000 |
| Suspense |  | 80,000 |
| Capital stock |  | 396,250 |
| Retained earnings |  | 168,340 |
|  | \$872,250 | \$872,250 |

You are able to determine that the current assets, current liabilities and allowance for depreciation are reasonably stated. In the course of your investigation you learn the following information:

1. The company was organized on January 1, 1950 as a successor to a single proprietorship operated by Arthur Growmore, president of Flowers, Inc. Mr. Growmore had previously developed an enviable reputation as a grower of quality flowers. At the date of incorporation, he invested assets with the following fair market values in exchange for 2,000 shares of $\$ 100$ par value stock: land (twenty acres), $\$ 50,000$; greenhouses, $\$ 100,000$. The Board of Directors passed a resolution stating the land and the greenhouses should be recorded at their fair market value and that tax consequences should be disregarded. However, the bookkeeper recorded the transaction in the following manner:

Real estate . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . \$200,000
Capital stock
\$200,000
The remaining 1,500 of the 3,500 shares authorized were sold to other stockholders at par.
2. On January 1, 1952 the stockholders agreed to donate one-quarter of their shares to the corporation as treasury stock to be sold to raise funds for
expansion. Mr. Growmore's donation was recorded by debiting Capital Stock $\$ 50,000$ and crediting Real Estate for the same amount. No entry was made to record the donation of 375 shares by other stockholders. All donated shares were resold to outsiders at 110 and the proceeds were credited to the Capital Stock account.
3. Additional land costing $\$ 54,000$ and buildings costing $\$ 99,000$ have been acquired since the corporation was organized.
4. As a result of condemnation proceedings, Flowers, Inc. sold eight acres of the land invested by Mr. Growmore to the county for construction of a school. The sale occurred on July 1, 1959 and the price was determined as follows:

Land-8 acres at $\$ 5,000$ per acre . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $\$ 40,000$
Flower crop growing on the land 37,000
Payment to cover nursery's cost of moving fence 3,000 $\$ 80,000$
5. The proceeds of the sale have been placed in a suspense account inasmuch as the company plans to replace the condemned land. According to the bookkeeper, the reason for doing this is that any gain or loss on the transaction cannot be determined until the cost of replacing the property is known, since for tax purposes this is an involuntary conversion.
6. On August 1, 1959 the nursery acquired a sixty-day option to purchase a five-acre plot near them. The $\$ 500$ paid for the option was charged to the Real Estate account. The option expired without being exercised.

On December 1, 1959 they acquired a ninety-day option on another piece of land, with no crops growing thereon, similar in size and quality to that obtained from them by the county as a result of condemnation proceedings. As of the date of your examination this option has not been exercised, but the company states that they intend to exercise the option and acquire the property. The $\$ 1,000$ paid for this option was also charged to the Real Estate account.
7. The company's provision for federal income tax has not been recorded; the tax is computed and amounts to $\$ 24,615$.

## Required:

a. A worksheet analysis of the Real Estate account.
b. Journal entries to record the adjustments which should be made to the accounts of Flowers, Inc.
c. A balance sheet as of December 31, 1959.

## GROUP II

Estimated time- 30 to 45 minutes. Solve only one problem in this group. If both are solved only the first will be considered.

## Number 5

In April, 1959, The Hardin Corporation stockholders approved the adoption of a "Deferred Compensation Plan for Officers and Key Employees" starting
with the calendar year ending December 31, 1959. The Plan provides, among other things

1. that allotments to participants under the Plan shall consist of cash or of cash and common stock of The Hardin Corporation;
2. that the cash allotment shall be paid in the year in which allotted and that the balance of the participants' allotment shall be payable solely in common stock of The Hardin Corporation;
3. that the stock so allotted shall be treasury stock purchased by the Corporation, and no authorized but unissued stock shall be used for purposes of the Plan;
4. that during the calendar year the total amount to be set aside and credited to the Deferred Incentive Compensation Fund shall be determined by the Board of Directors but shall not exceed the following:
$\$ .40$ of the 1 st $\$ 1.00$ per share earned in excess of $\$ 1.50$ per share
$\$ .30$ of the 2 nd $\$ 1.00$ per share earned in excess of $\$ 1.50$ per share
$\$ .20$ of the 3rd and each succeeding $\$ 1.00$ per share earned in excess of $\$ 1.50$ per share
or a proportionate amount of any fraction of a dollar.
Earnings per share shall be based on The Hardin Corporation's net income, after provision for federal income taxes (calculated at the rates in effect during $1959-52 \%$ less $\$ 5,500$ ), but before the provision contemplated by this Plan and its tax effect and on the average number of shares of common stock of the Corporation outstanding during the calendar year (computed on an average monthly basis to the nearest 10 shares).

However, the maximum amount to be set aside from such earnings in excess of $\$ 1.50$ per share for the purposes of this Plan shall not in any year exceed $18 \%$ of the net income for the year after federal taxes but before provision for deferred incentive compensation.

At December 31, 1959 the records of the Corporation reflect the following data:
a. On December 10, 1959 the Board of Directors approved a provision for deferred incentive compensation in the amount of $\$ 76,000$ for the year ended December 31, 1959. Of this amount, $20 \%$ was to be paid in cash prior to December 31, 1959, and the balance set aside for stock allotment. (The cash portion was paid on December 29, 1959.)
b. The condensed statement of income for the year ended December 31, 1959 follows:

| Net sales |  | \$5,448,341 |
| :---: | :---: | :---: |
| Costs and expenses: |  |  |
| Cost of goods sold | \$3,765,000 |  |
| Selling and administrative | 799,000 |  |
| Provision for deferred incentive compensation | 76,000 | 4,640,000 |
| Operating income |  | 803,341 |
| Provision for federal income taxes (52\% less \$5,500) |  | 414,837 |
| Net income |  | \$ 393,504 |

c. Analysis of the common stock accounts show that there were 150,000 shares of common stock authorized at December 31, 1958 and 1959, and 140,000 shares issued and outstanding at December 31, 1958. On June 1, 1959 the Corporation purchased, in the open market, 9,651 shares of its stock at an average price of $\$ 20.75$ per share, which shares were held in the treasury at December 31, 1959. There were no other changes in common stock during the year.
d. You are advised that the total provision for deferred incentive compensation in any year is an acceptable federal income tax deduction in the year provided, if in accordance with the terms of the plan.

## Required:

A statement in good form showing the computations of the maximum amounts available for deferred incentive compensation as computed under the two limitations set forth in the Plan.

## Number 6

The Village of Hope, by referendum on November 30, 1958, was authorized to sell bonds, the proceeds of which were to be used for constructing a municipal building to provide adequate facilities for the offices and departments of the Village. The cost of the building was estimated to be $\$ 90,000$, and the ordinance provided for the issuance of general obligation bonds in that amount, at an interest rate of 3 per cent per annum. Bonds were to be dated January 1, 1959 and were to become due and payable in equal annual installments on January 1 of each of the years 1961 to 1969, inclusive. Interest was to be due semiannually on January 1 and July 1, except that the first coupon was to be due on July 1, 1960. Bonds were to be payable out of the proceeds of a direct annual tax sufficient to pay the principal and interest when due.

The Village advertised for bids on the bonds, and on January 15, 1959, the bids were opened and the bonds awarded to Municipal Bond Company. The following transactions occurred:

1. November 30, 1958-Bonds were authorized in accordance with the referendum.
2. February 1, 1959-Bonds were sold to Municipal Bond Company and a certified check was received in the amount of $\$ 93,636$, including premium and accrued interest at 3 per cent to date of sale.
3. February 10,1959 -Initial architectural fees of $\$ 2,000$ were paid to the firm which prepared the plans and specifications and was to have construction supervision. The fee for their services was to be 6 per cent of the building cost.
4. April 15, 1959-The general contractor had bid $\$ 81,400$ to construct the building. The first contractor's estimate in the amount of $\$ 30,000$ was received from the architect, properly approved. The estimate was paid, less 10 per cent retained until the building was accepted by the Village.
5. July 30, 1959 (Entry as of September 1, 1959)—The appropriation ordinance of the Village for the fiscal year ending August 31, 1960 was adopted. The ordinance contained provision for the retirement of the bonds due on January 1,1961 and interest due through that date. It has been the experience of the Village that the tax levy should provide an additional 3 per cent to provide for losses and costs on collection.
6. September 20, 1959-The final contractor's invoice was received in the amount of $\$ 54,500$, including approved extras totaling $\$ 3,100$. The invoice was paid less a 10 per cent retention. At the same time, an invoice in the amount of $\$ 2,000$ was paid to the architects.
7. December 21, 1959-Final approval of the building was given by the architect and the Board of Trustees and final payments were made to the general contractor and architect.

## Required:

Journalize the above transactions. Prepare entries for each of the applicable funds, and key the entries to the transaction number indicated. No entries need be considered to close out the various revenue and expenditure accounts at August 31, 1959.

# EXAMINATION IN ACCOUNTING PRACTICE-PART II 

## May 19, 1960; 1:30 p.m. to 6:00 p.m.

## GROUP I

## Solve all problems in this group.

## Number 1 (Estimated time- 25 to 35 minutes)

You are the accountant for the White Corporation and receive a telephone call from their bookkeeper informing you that the corporation has sold a storage building and land. You have submitted a list of annual adjusting entries for this client as of December 31 each year. The sale of the property took place as of June 30, 1959, and the bookkeeper requests that you advise her how to record the transaction. You advise her to open an account called "Sale of property" and credit the account with the proceeds and charge same with expenses paid in connection with the sale, if any, and you will complete the recording when you make your next audit.

The escrow statements were as follows:
Seller's Statement

| Selling price |  |  | \$34,000.00 |
| :---: | :---: | :---: | :---: |
| Cash due from- |  |  |  |
| Bank | \$14,740.27 |  |  |
| Buyer | 6,725.75 | \$21,466.02 |  |
| Purchase money second mortgage . <br> Balance 1958 taxes to be paid by bank |  | 12,000.00 |  |
|  |  | 166.53 |  |
| Tax adjustment for 1959: <br> Credit to buyer-6 months |  |  |  |
|  |  | 354.75 |  |
| Revenue stamps |  | 35.20 |  |
| Insurance adjustment-credit to seller |  |  | 22.50 |
|  |  | \$34,022.50 | \$34,022.50 |
| Buyer's Statement |  |  |  |
| Purchase price |  | \$34,000.00 |  |
| Cash due to seller |  |  | \$ 6,725.75 |
| Insurance adjustment |  | 22.50 |  |
| Title fee and recording |  | 58.00 |  |
| Tax adjustment for 1959 |  |  |  |
| First mortgage to bank ........ |  |  | $\begin{array}{r} 15,000.00 \\ 12,000.00 \\ \hline \end{array}$ |
|  |  | \$34,080.50 | \$34,080.50 |

Note:
The bank will deduct from the $\$ 15,000$ (first mortgage) the following items:

| 1958 Taxes | \$166.53 |  |
| :---: | :---: | :---: |
| Revenue stamps | 35.20 |  |
| Title fee and recording | 58.00 | 259.73 |
| Net due from bank |  | 14,740.27 |
| Net due from buyer |  | 6,725.75 |
| Total due seller |  | \$21,466.02 |

Property taxes are assessed on December 31 of each year and are payable either in full the following September or the first of four quarterly installments is due on that date. Included in the accrued tax account are:

1. The balance of the 1958 taxes
\$166.53
2. One-half the 1959 assessment 354.75*
Total
$\$ 521.28$
*This represents the estimated tax expense applicable to the first six months of 1959.
During your subsequent quarterly audit, you find the following facts:
3. The property was purchased January 1, 1956 at a total cost of $\$ 32,000$, $\$ 30,000$ for the building and $\$ 2,000$ for the land.
4. Depreciation is booked annually at $21 / 2 \%$, and the accumulated provision at December 31, 1958 is $\$ 2,250$.
5. The account, Sale of Property, contains a credit of $\$ 21,466.02$ (funds received from sale) and a debit of $\$ 500$ which is a commission paid to an individual who obtained the buyer.

## Required:

a. Journal entries to complete the recording of the transaction on White Corporation's books.
b. A schedule showing the gain or loss.

## Number 2 (Estimated time- $\mathbf{3 0}$ to 50 minutes)

The Trinity Construction Company was organized on January 1, 1959 as a partnership engaged in the building of school facilities. The books of the company are found to reflect only the cash receipts and cash disbursements for the year, but the partners elect to report the income on a completed-contract basis with overhead charged to periodic income, and have requested that you prepare the financial statements for the calendar year 1959. The profits and losses of the partnership are to be divided equally between the partners.

A trial balance taken from the books of the firm at December 31, 1959 follows:

|  | Debits | Credits |
| :---: | :---: | :---: |
| Cash | \$ 69,874.50 |  |
| Equipment | 30,000.00 |  |
| Accrued withholding taxes payable |  | \$ 800.00 |
| Accrued payroll taxes |  | 74.50 |
| A, Capital |  | 30,000.00 |
| B, Capital |  | 32,000.00 |
| Construction income |  | 940,000.00 |
| Construction costs | 885,600.00 |  |
| Overhead expenses | 17,400.00 |  |
|  | \$1,002,874.50 | \$1,002,874.50 |

The information below was obtained from the partners and an examination of the records, invoices and contracts.

|  | Contract Price | Estimated Cost Per Contract | Actual Costs Incurred During Year 1959 Excluding Depreciation | Billings <br> During Year | Cash <br> Received On <br> Contracts |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Job No. 1 | \$200,000 | \$170,000 | \$171,000 | \$200,000 | \$200,000 |
| Job No. 2 | 280,000 | 240,000 | 180,000 | 210,000 | 195,000 |
| Job No. 3 | 160,000 | 137,500 | 135,000 | 160,000 | 160,000 |
| Job No. 4 | 500,000 | 450,000 | 225,000 | 220,000 | 180,000 |
| Job No. 5 | 90,000 | 70,000 | 63,000 | 81,000 | 75,000 |
| Job No. 6 | 340,000 | 300,000 | 45,600 | 50,000 | 40,000 |
| Job No. 7 | 95,000 | 82,000 | 81,000 | 95,000 | 90,000 |

All jobs are billed on a percentage of completion basis.
Job Nos. 1, 3 and 7 were completed during the year. All of the remaining jobs are still in process and no losses are indicated or anticipated on them. Job No. 4 has a retained percentage provision whereby the school district retained 10 per cent of each billing until the contract is completed.

It was found that $\$ 600$ of the construction costs of Job No. 6 was for materials used for an addition to the home of partner A.

Taxable wages in the amount of $\$ 10,000$ were paid in the last quarter of 1959 and charged as follows: Job No. 2-\$4,000, Job No. 4-\$4,000 and Job No. 5$\$ 2,000$. The wages were subject to a total unemployment tax rate of 3 per cent and F.I.C.A. tax rate of $2 \frac{1}{2} \%$.

The payroll deductions in the 4th quarter were $\$ 248.50$ on F.I.C.A. taxes and $\$ 2,500$ on F.I.T. withholding; $\$ 2,048$ had been deposited with a federal depository for these deductions.

All the equipment was acquired in January, 1959 through a liquidation sale of another contractor and is estimated to have a remaining life averaging five years. The partners elected the straight-line method of depreciation.

## Required:

A worksheet showing the adjustments to convert cash basis account balances to completed-contract basis. Key and explain all adjustments, and prepare supporting schedules for any major adjustments.

## Number 3 (Estimated time- 35 to 50 minutes)

Thomas Trauma had been engaged, as a sole proprietor, in the manufacture and sale of drug products for the past nineteen years. On September 1, 1958 Mr. Trauma organized Tommy's Tranquilizers, Inc., which corporation thereupon acquired all of the assets, business and goodwill of Mr. Trauma's proprietorship in exchange for all of its capital stock. The corporation made the following entry to record this transaction on its books:


All of the above-listed assets are stated at their bases to the proprietorship except for goodwill, for which Mr. Trauma had no cost basis.

The corporation's first fiscal year ended June 30, 1959 and as of that date, its preclosing trial balance was as follows:
Cash

Trade accounts receivable . . . . . . . . . . . . . . . . . .


Trade accounts payable and accrued expenses .
Capital stock
Sales
Gain on disposition of spleen pill business
Purchases ........... . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $\quad 300,000$
Productive labor . . . . . . . . . .

Productive labor 370,000
Other manufacturing costs 100,000
Other salaries and wages 350,000
Advertising 400,000
Rent
60,000
Taxes 36,000
Professional fees 4,000
Organization expenses 54,000
Pension plan expenses 6,000 \$3,260,000
\$ 270,000 120,000 500,000
2,000,000
370,000(1)
$\$ 3,260,000$

1. Sale of spleen pill business:

On April 7, 1959 the corporation sold all of the goodwill, customer lists, patent rights, etc., of its spleen pill business to Buyemup Industries. The spleen pill business had been originally developed by Mr. Trauma under basic patents granted in 1939. Gain on the transaction was computed as follows:

> Selling price.$\ldots \ldots \ldots$ Portion of goodwill transferred by Mr. Trauma to corporation allocable to spleen pill business $\ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots$

Gain on sale ................................................ $\overline{\$ 370,000}$
The balance due from Buyemup is payable on August 7, 1959.

## 2. Inventory:

No entries have been made in the inventory account since the date of incorporation. The physical inventory taken on June 30, 1959 totaled $\$ 100,000$.

## 3. Land and building:

On January 1, 1959 the corporation purchased a one-year-old building at a total cost of $\$ 400,000$, of which amount $\$ 100,000$ is allocable to cost of the land. No depreciation entry has yet been made in the accounts with respect to the building, which had an estimated remaining life of 25 years from date of purchase.

## 4. Equipment:

No depreciation on equipment has yet been reflected in the accounts. An analysis of the equipment account since date of incorporation follows:

| Date |  | Item | Estimated <br> Remaining <br> Life |
| :--- | :--- | :--- | :--- |

5. Deferral patent expense:

Following is an analysis of the deferred patent account, as of June 30, 1959:
Patent No. 145876-Purchased November 1, 1958 from A. H. Bobble. Patent expires May 1, 1964
\$ 66,000
Patent No. 269487-Granted to Tommy's Tranquilizers, Inc. February 1, 1959:
Legal and other fees relating to securing patent $\$ 7,000$
Labor and expenses re developing patent $\ldots \ldots .3$ 33,800 40,800
Project No. 1-Patent application filed June 1, 1959 (patent granted August 1, 1959):
Legal and other fees relating to securing patent 6.000
Labor and expenses re developing patent $\ldots \ldots$.... 30,000 36,000
Project No. 2-In development stage:
Labor and expenses to June 30, 1959
27,200
$\$ 170,000$
You have been asked to prepare the corporation's U. S. corporation income tax return for the period from September 1, 1958 (date of incorporation) to June 30, 1959. The company desires to take advantage of every election available to it under the Internal Revenue Code in order to pay the lowest possible tax.

## Required:

a. Compute taxable income for the period. Show details of adjustments necessary to arrive at the amount of taxable income, supporting major adjustments with schedules.
b. Compute the amount of federal income tax due for the period.

## Number 4 (Estimated time- 55 to 80 minutes)

The Vanguard Corporation is primarily a sales organization. The corporation has approximately 1,000 stockholders and its stock, which is traded "over-thecounter," sold throughout 1959 at about $\$ 7$ a share with little fluctuation.
Below is the corporation's balance sheet at December 31, 1958:

# VANGUARD CORPORATION 

Balance Sheet<br>December 31, 1958

| Assets |  |  |
| :---: | :---: | :---: |
| Current assets |  |  |
| Cash |  | \$ 4,386,040 |
| Accounts receivable | \$3,150,000 |  |
| Less allowance for doubtful accounts | 94,500 | 3,055,500 |
| Inventories-at the lower of cost (firstout) or estimated realizable market |  | 2,800,000 |
| Total current assets |  | 10,241,540 |
| Fixed assets-at cost | 3,300,000 |  |
| Less accumulated depreciation | 1,300,000 | 2,000,000 |
| Total assets |  | \$12,241,540 |


| Current liabilities |  |  |
| :---: | :---: | :---: |
| Notes payable due within one year |  | \$ 1,000,000 |
| Accounts payable and accrued liabilities |  | 2,091,500 |
| Federal income taxes payable |  | 350,000 |
| Total current liabilities |  | 3,441,500 |
| Notes payable due after one year |  | 4,000,000 |
| Stockholders' equity |  |  |
| Capital stock-authorized 2,000,000 shares of |  |  |
| \$1 par $1,000,000$ value; issued and shares | \$1,000,000 |  |
| Additional paid-in capital | 1,500,000 |  |
| Retained earnings . . . . . | 2,300,040 |  |
| Total stockholders' equity |  | 4,800,040 |
| Total liabilities and stockholders' equity |  | \$12,241,540 |

Information concerning the corporation and its activities during 1959 follows:

1. Sales for the year were $\$ 15,650,000$. The gross profit percentage for the year was $30 \%$ of sales. Merchandise purchases and freight-in totaled $\$ 10,905,000$. It can be assumed that depreciation and other expenses do not enter into cost of goods sold.
2. Administrative, selling and general expenses (including provision for state taxes) other than interest, depreciation and provision for doubtful accounts amounted to $\$ 2,403,250$.
3. The December 31, 1959 accounts receivable were $\$ 3,350,000$ and the corporation maintains an allowance for doubtful accounts equal to $3 \%$ of the accounts receivable outstanding. During the year $\$ 50,000$ of 1958 receivables were deemed uncollectible and charged off to the allowance account.
4. The rate of depreciation of fixed assets is $13 \%$ per annum and the corporation consistently follows the policy of taking one-half year's depreciation in the year of acquisition. The depreciation expense for 1959 was $\$ 474,500$.
5. The notes are payable in twenty equal quarterly installments commencing March 31, 1959 with interest at $5 \%$ per annum also payable quarterly.
6. Accounts payable and accrued liabilities at December 31, 1959 were $\$ 2,221,000$.
7. The balance of the 1958 federal income tax paid in 1959 was in exact agreement with the amount accrued on the December 31, 1958 balance sheet.
8. For purposes of the 1959 estimated tax payments the controller estimated the total 1959 tax to be $\$ 800,000$.
9. During the second month of each quarter of the year 1959 dividends of $\$ .10$ a share were declared and paid. In addition, in July 1959 a $5 \%$ stock dividend was declared and paid.

## Required:

The following statements in good form, supported by well-organized and detailed computations, at or for the year ended December 31, 1959:
a. Balance Sheet.
b. Statement of Earnings.
c. Statement of Retained Earnings.

## GROUP II

## Estimated time-35 to 55 minutes

Solve only one problem in this group. If both are solved, only the first will be considered.

## Number 5

You are engaged in the annual audit of The Sunset Company, a manufacturer of oil field equipment and parts. At May 31, 1959, end of Company's fiscal year, the finished goods inventory is stated on Company's books at $\$ 860,500$. The Company priced the inventory at moving average manufacturing cost. In your test of the net realizable value of the inventory, you selected representative items totaling $\$ 344,235$ for comparison with net selling prices on the most recent sales invoices (less $15 \%$ for selling expenses). Included in the test were four parts which have comparable value relationships.

| Part <br> Number | Per 5/31/59 Inventory |  | 5/31/59 <br> Most Recent Cost to Produce | Latest Net Selling Price |
| :---: | :---: | :---: | :---: | :---: |
|  | Units | Unit Price |  |  |
| 113250 | 6 | \$4,425 | \$4,154 | \$3,904.41 |
| 113475 | 2 | 3,180 |  |  |
| 113625 | 3 | 7,250 |  |  |
| 113830 | 1 | 5,435 |  |  |

On all other items included in your test, except for two items requiring special consideration, you determined that the inventory was stated in excess of net realizable value by $\$ 46,938.55$.

In addition, there are two items, not included in the above test, in the May 31, 1959 inventory, which require special consideration.

1. One drawworks priced at $\$ 55,000$.

This drawworks was manufactured at a cost of $\$ 140,000$ and was written down to the $\$ 55,000$ amount at the end of the preceding year. The Company expects to sell this drawworks for $\$ 96,000$ and you have examined correspondence which tends to support this.
2. One slush pump priced at cost of $\$ 40,000$.

This is the first pump of this type produced by Company. The Company expects to sell this pump for $\$ 38,000$ less a $25 \%$ discount.

## Required:

Assuming that your test is representative and valid, and taking into account the two special items above, compute the amount of write-down necessary to state the May 31, 1959 inventory at net realizable value.

## Number 6

Following is the previously computed standard cost of Product X , manufactured by the XYZ Manufacturing Company:

|  | Prime Cost | Manufacturing <br> Burden-50\% | Total |
| :---: | :---: | :---: | :---: |
| Material A | \$10 |  | \$10.00 |
| Material B | 5 |  | 5.00 |
| Material C | 2 |  | 2.00 |
| Direct Labor-Cutting | 8 | \$4.00 | 12.00 |
| Direct Labor-Shaping | 4 | 2.00 | 6.00 |
| Direct Labor-Assembling | 2 | 1.00 | 3.00 |
| Direct Labor-Boxing | 1 | . 50 | 1.50 |
| Total | \$32 | \$7.50 | \$39.50 |

The budget called for the manufacture of 10,000 of Product X at a total cost of $\$ 395,000$ for the period under review.

The following variance accounts relating to Product X appear on the books for the period:

|  | Debit | Credit |
| :---: | :---: | :---: |
| Material price variance |  |  |
| Due to a favorable purchase of total requirements of Material A |  | \$19,500 |
| Material usage variance |  |  |
| Excessive waste during period | \$ 3,000 |  |
| Labor rate variance |  |  |
| $5 \%$ wage increase to direct workers$7,500$ |  |  |
|  |  |  |
| Due to shut-down caused by strike $\ldots . . . . . . . .$. 15,000Burden variance-fixed overhead |  |  |
|  |  |  |
| Due to shut-down caused by strike | 6,000 |  |
| Burden variance-variable overhead |  |  |
| Due to permanent savings in costs of certain services |  | 12,000 |
| Totals | \$31,500 | \$31,500 |


| The inventory at the end of the period is as follows: |  |  |
| :---: | :---: | :---: |
| 100 units Material A | \$10.00 | \$ 1,000 |
| 100 units Material B | 5.00 | 500 |
| 100 units Material C | 2.00 | 200 |
| 200 units Product X in process-cut | 29.00 | 5,800 |
| 200 units Product X in process-shaped | 35.00 | 7,000 |
| 200 units Product X in process-assembled | 38.00 | 7,600 |
| 200 units Product X finished and boxed | 39.50 | 7,900 |
| Total |  | \$30,000 |

## Required:

a. A schedule of revised standard cost which will clearly indicate the cumulative standard for each successive operation.
b. A schedule applying the revised standard to the ending inventory.

## EXAMINATION IN AUDITING

May 19, 1960; 8:30 a.m. to $12: 00 \mathrm{~m}$.

## GROUP I

## Answer all questions in this group.

## Number 1 (Estimated time- 10 to 15 minutes)

The independent certified public accountant's report, opinion, or certificate as it is variously termed, conventionally includes the following ". . . and accordingly included such tests of the accounting records . . . as we considered necessary in the circumstances."

## Required:

Explain how the accountant determines what tests are necessary and the extent to which they are necessary.

## Number 2 (Estimated time- 15 to 20 minutes)

Wee Incorporated, a small manufacturing company, has appointed you to make an audit and issue an opinion for the 1959 calendar year. In January 1959, the nine shareholders (all individuals) elected to be taxed as a small business corporation for 1959 and later years under certain sections of the Internal Revenue Code.

In brief, these sections provide that where an election is made the shareholders include in their own income for tax purposes the current taxable income of the corporation, both the part which is distributed and that which is not.

In the course of your 1959 audit, you did not uncover any item which would preclude you from issuing an unqualified report.

## Required:

As a result of the election to have the federal income tax on the corporate income paid directly by its stockholders, the following questions are raised:
a. Should footnote disclosure be made of the election by the corporation shareholders? Explain.
b. What information should be given to each stockholder at the end of the year to facilitate the preparation of his tax return? Explain.
c. Explain the type of auditor's report you would issue under these circumstances.

## Number 3 (Estimated time- 20 to 30 minutes)

You are in the process of "winding up" the field work on XYZ Stove Corporation, a company engaged in the manufacture and sale of kerosene space heating stoves. To date there has been every indication that the fianancial statements of
the client present fairly the position of the company at December 31, 1959 and the results of its operations for the year then ended. The company had total assets at December 31, 1959, of $\$ 4$ million and a net profit for the year (after deducting federal and state income tax provisions) of $\$ 285,000$. The principal records of the company are a general ledger, cash receipts record, voucher register, sales register, check register and general journal. Financial statements are prepared monthly. Your field work will be completed on February 20 and you plan to deliver the opinion statements to the client by March 12.

## Required:

a. Prepare a brief statement as to the purpose and period to be covered in a post-audit review of material transactions.
b. Outline the post-audit review program which you would follow to determine what transactions involving material amounts, if any, have occurred since the balance sheet date.

## Number 4 (Estimated time- 25 to 35 minutes)

In many companies, labor costs represent a substantial percentage of total dollars expended in any one accounting period. One of the auditor's primary means of verifying payroll transactions is by a detailed payroll test.

You are making an annual examination of the Joplin Company, a mediumsized manufacturing company. You have selected a number of hourly employees for a detailed payroll test. The following worksheet outline has been prepared.

| Column <br> Number | Column Heading |
| :---: | :---: |
| 1 | Employee number |
| 2 | Employee name |
| 3 | Job classification |
|  | Hours worked |
| 4 | Straight time |
| 5 | Premium time |
| 6 | Hourly rate |
| 7 | Gross earnings |
|  | Deductions |
| 8 | F.I.C.A. withheld |
| 9 | F.I.T. withheld |
| 10 | Union dues |
| 11 | Hospitalization |
| 12 | Amount of check |
| 13 | Check and check number |
| 14 | Account number charged |
| 15 | Description of account |

## Required:

a. What factors should the auditor consider in selecting his sample of employees to be included in any payroll test?
b. Using the column numbers above as a reference, state the principal way(s) that the information in each column would be verified.
c. In addition to the payroll test, the auditor employs a number of other audit procedures in the verification of payroll transactions. List five additional procedures which may be employed.

## Number 5 (Estimated time- $\mathbf{3 0}$ to 40 minutes)

You are a senior accountant on the staff of Marin and Matthews, certified public accountants. You are conducting the annual audit of the Never-Slip Corporation for the calendar year 1959.

You are now working on the audit of the accounts receivable and related allowance for bad debts accounts. The study of the internal control has been completed, and the audit program has been completely carried out.

All data and information for the setting up and completion of your working papers are summarized below.

General Ledger

| Accounts Receivable |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| 1959 <br> Dec. 31 |  |  |  |  |  |
|  | Balance | \$184,092.42 |  |  |  |
| Allowance for Bad Debts |  |  |  |  |  |
| 1959 |  |  | 1959 |  |  |
| July 31 | G.J. | \$570.00 | Jan. 1 | Balance | \$2,712.50 |
| Oct. 31 | G.J. | $954.16$ | Dec. 31 | G.J. | 2,698.10 |
| 1959 |  |  | 1959 |  |  |
| Dec. 31 | G.J. | \$2,698.10 | Aug. 1 | C.R.J. | \$85.00 |

## General Journal

## July 31



October 31

| Allowance for bad debts |  | 954.16 |
| :---: | :---: | :---: |
| Accounts receivable |  | 954.16 |
| Accounts charged off: |  |  |
| Baker, J. A. | \$110.00 |  |
| Dehner \& Son | 9.75 |  |
| Meek, Roger | 350.00 |  |
| Wagner, James | 494.41 |  |
|  | \$954.16 |  |

December 31

| Bad debts | 2,698.10 |  |
| :---: | :---: | :---: |
|  |  |  |
| Allowance for bad debts Annual charge based on |  | 2,698.10 |

## Cash Receipts Journal

On August 1 the $\$ 85$ account of John Smith, previously charged off as of July 31, was collected in full. Credit was to bad debts.

## Summary of Aging Schedule

The summary of the subsidiary ledger as of December 31, 1959 was totaled as follows:

| Under one month | \$ 92,715.60 |
| :---: | :---: |
| One to three months | 58,070.15 |
| Three to six months | 29,126.89 |
| Over six months | 4,624.10 |
|  | \$184,536.74 |

Credit balances:
Dabney Cleaners .. \$ 16.54-O.K.-Additional billing in January 1960
Britting Cafeteria 72.00 -Should have been credited to Britt Motor Co.* Wehby \& Son 384.00 -Advance on a sales contract $\$ 472.54$
*Account is in one to three months classification.
The customers' ledger is not in agreement with the accounts receivable control. The client instructs the auditor to adjust the control to the subsidiary ledger after any corrections are made.

## Allowance for Bad Debt Requirements

It is agreed that $1 / 2 \%$ is adequate for accounts under one month.
Accounts one to three months are expected to require a reserve of $1 \%$.
Accounts three to six months are expected to require a reserve of $2 \%$.
Accounts over six months are analyzed as follows:

| Definitely bad | \$ 416.52 |
| :---: | :---: |
| Doubtful (estimated $50 \%$ collectible) | 516.80 |
| Apparently good, but slow (estimated $90 \%$ collectible) | 3,690.78 |
|  | \$4,624.10 |

## General Notes

The general ledger has not been closed.
The allowance for bad debts account is to be adjusted to the required amount determined after all adjustments and corrections have been made.

## Required:

a. Prepare audit working papers in reasonable detail for the accounts receivable and allowance for bad debts accounts. Introduce any new accounts or more discriminating classifications if advisable. Make appropriate cross references by numbers in parentheses.
b. Prepare correcting entries with adequate explanations and key to the working papers.

## GROUP II

## Estimated time- 50 to 70 minutes

## Answer only two questions in this group. If three are answered only the first two will be considered.

## Number 6

Kent County Grain and Milling Company decided to stimulate the sale of its flour by including a coupon, redeemable for fifty cents ( $50 \phi$ ), in every twenty-five- and fifty-pound sack of flour produced subsequent to October 1, 1959. The company contemplates that 150,000 coupons will be in the hands of customers before completion of the promotional campaign on March 31, 1960.

Upon commencing your year-end work on January 10, 1960, for the calendar year ending December 31, 1959, the controller of Kent County Grain and Milling Company requested that you review the accounting records and the internal accounting controls applicable to the flour coupons.

In your review of the accounting records and the system of internal accounting controls, you learned the following:

1. A perpetual record of coupons received, damaged, and used is kept by the production superintendent. Coupons received from the printer are entered from a copy of the receiving ticket, damaged coupons are reported orally by a line foreman, and coupons used are entered from a copy of the production report of sacks of flour packed. A summary of the perpetual record as of December 31, 1959 is as follows:

| Coupons received to dat | 150,000 |
| :---: | :---: |
| Coupons damaged and destroyed | $(2,000)$ |
| Coupons included in 25 lb . sacks of flour | $(50,000)$ |
| Coupons included in 50 lb . sacks of flour | $(25,000)$ |
| On hand per record | 73,000 |

2. Unused coupons are kept in a storeroom with stationery and supplies and are readily accessible. No count of coupons within a package is made as they are received from the printer; however, the number of packages times the indicated amount in each package is recorded on a receiving ticket which is later agreed, in the office, with a copy of the vendor's invoice.
3. Coupons are sometimes damaged by the machinery which mechanically inserts them in the sacks. The production superintendent said that he thought that the line foreman destroyed these coupons. As previously mentioned, the number of damaged coupons is reported to the production superintendent orally each day by the line foreman.
4. The line foreman takes a quantity of unused coupons from the storeroom each day based upon scheduled production for that day.
5. Correspondence containing coupons mailed to the company for redemption is first opened in the mail department. The coupons are then sent to the cashier's department where they are redeemed in cash out of a fund especially set up for that purpose. The cashier places a fifty-cent piece in a self-addressed
envelope, seals the envelope, and returns it to the mail department for ultimate disposition. The cashier stamps the coupon paid with the date of payment.
6. Once each week the cashier's coupon fund is reimbursed in the same manner as any other imprest fund.
7. Complaints from customers not receiving their fifty-cent pieces are sent to the cashier for disposition.

You also learned that a physical inventory of unused coupons was taken on December 31, 1959. It was found that 71,250 coupons were on hand. As of December 31, 1959, flour containing 50,000 coupons had been sold to the company's retail outlets. In addition, by December 31, 1959, 37,500 coupons had been redeemed and paid, and it was estimated that only 50 per cent of the remaining coupons outstanding at that time would be redeemed.

## Required:

a. Prepare a memorandum to the controller as to weaknesses in his present control procedures in regard to handling redeemable coupons and your recommendations for improvement.
b. Prepare a journal entry setting up the company's liability for unredeemed coupons as at December 31, 1959. Show your method of computing the liability.

## Number 7

Line-Rite Manufacturing Company, Inc. is a moderate-sized company manufacturing equipment for use in laying pipe lines. The company has prospered in the past, gradually expanding to its present size. Recognizing a need to develop new products, if its growth is to continue, the company created an engineering research and development section. During 1959, at a cost of $\$ 70,000$, this section designed, patented and successfully tested a new machine which greatly accelerates the laying of small-sized lines.

In order to adequately finance the manufacture, promotion and sale of this new product it has become necessary to expand the company's plant and to enlarge inventories. Required financing to accomplish this has resulted in the company engaging you in April 1959 to examine its financial statements as of September 30, 1959, the end of the current fiscal year. This is the company's initial audit.

In the course of your preliminary audit work you obtain the following information:

1. The nature of the inventory and related manufacturing processes do not lend themselves well to taking a complete physical inventory at year-end or at any other given date. The company has an inventory team which counts all inventory items on a cycle basis throughout the year. Perpetual inventory records, maintained by the accounting department, are adjusted to reflect the quantities on hand as determined by these counts. At year-end an inventory summary is prepared from the perpetual inventory records. The quantities in this summary are subsequently valued in developing the final inventory balances.
2. The company carries a substantial parts inventory which is used to service equipment sold to customers. Certain parts are also used in current pro-
duction. The company considers any part to be obsolete only if it shows no usage or sales activity for two consecutive years. Parts falling into this category are reserved for fully. A reserve of $\$ 10,000$ exists at present.

Your tests indicate that obsolescence in inventories might approximate $\$ 50,000$. As part of your audit you must deal with each of the foregoing matters.

## Required:

a. With respect to inventories define the over-all problem involved in this first audit.
b. Outline a program for testing inventory quantities.
c. Enumerate and discuss the principal problems involved in inventory obsolescence for the company assuming the amount involved was significant with respect to the company's financial position.

## Number 8

In examining the books of a manufacturing concern, you find on the December 31, 1959 balance sheet, the item, "Costs of patents, $\$ 18,780$."

Referring to the ledger accounts, you note the following items regarding one patent acquired in 1945:

$$
\begin{aligned}
& 1955 \text { Legal costs incurred in defending the validity of the patent . . } \$ 1,500 \\
& 1957 \text { Legal costs in prosecuting an infringement suit ............. } 1,100 \\
& 1957 \text { Legal costs (additional expenses) in the infringement suit .... } 340 \\
& 1957 \text { Cost of improvements (unpatented) on the patented device .. } 900
\end{aligned}
$$

There are no credits in the account and no allowance for amortization has been set up on the books for any of the patents. There are three other patents issued in 1953, 1955, and 1956; all were developed by the staff of the client. The patented articles are presently very marketable, but are estimated to be in demand only for the next few years.

## Required:

a. What auditing procedures of all the patents should be included in your work program and what details of patented articles should appear in the permanent file?
b. Discuss the items included in the patent account both from accounting and federal income tax standpoints.

# EXAMINATION IN COMMERCIAL LAW 

May 20, 1960; 8:30 a.m. to 12:00 m.

## All questions are required.

## Number 1 (Estimated time- $\mathbf{1 5}$ to 25 minutes)

You will find below a series of fact situations describing various steps in the sale of merchandise. All of the facts for each question are to be identical with those stated in item number 1, unless specifically modified in the particular case.

Given below is a group of answer choices with a series of statements, each preceded by a letter. You are to select that statement which describes the event by which both parties first became bound to the terms of a contract. Indicate your selection by placing the applicable letter on an answer sheet corresponding to the item number for which you are selecting an answer.

## Answer Choices

a. R (or T ) mailed his order.
b. W received the order.
c. W mailed acceptance (or rejection) of order to R (or T ).
d. $\mathbf{R}$ (or T ) received the acceptance (or rejection).
e. W sent telegram.
f. $R$ received telegram from W.
g. R sent telegram.
h. W received telegram from R.
i. W shipped the merchandise.
j. R received the merchandise.
k. After a reasonable time for rejection to be received.
z. The parties did not become bound to a contract.

1. W was a wholesaler, who for several years had regularly sold merchandise to R , who operated a retail store in a neighboring state. W mailed a letter to R , asking him to purchase ten bicycles at $\$ 27.50$ each. R ordered "ten bicycles at your quoted price" by return mail. W immediately mailed his acceptance of the order.
2. Same as 1 , except instead of a letter, W mailed a price list, giving different prices for various quantities ordered.
3. Same as 1 , except T, another retailer, read W's letter to $R$ and mailed his order to W for ten bicycles.
4. Same as 1 , except the letter quoted bicycles at $\$ 2.75$. R had purchased bicycles recently at $\$ 27.50$.
5. Same as 2 , except R ordered ten at the listed price of $\$ 25$.
6. Same as 1 , except after $W$ had mailed the letter, he sent a telegram raising the price. R mailed his order, then R received the telegram, and W received the order. W mailed acceptance of the order.
7. Same as 6 , except that upon receiving the telegram, $R$ telegraphed a cancellation of the order. This telegram was received by W before the order. W mailed acceptance of the order.
8. Same as 1 , except that W's letter provided that all orders were to be received subject to approval at W's office.
9. Same as 1, except R's order provided, "This order shall be effective only upon receipt of confirmation."
10. Same as 1 , except that R's order provided, "This order shall be null and void unless I receive the merchandise by March 31, 1960." W's acceptance read, "Your order shipped March 28, 1960, should arrive next day." The acceptance arrived March 30, 1960. The merchandise was received April 2, 1960.
11. Same as 1 , except W's letter stated that the offer would remain open until March 31, 1960. R posted his order on March 31, 1960 but it was improperly addressed and thus not received until April 2, 1960.
12. Same as 1 , except W's letter requested an answer by return mail. $R$ sent his order by telegram.
13. Same as 1 , except that after receiving $W$ 's letter $R$ wrote to $W$ asking for a lower price. R later sent a telegram ordering ten at the original quoted price The letter was delivered first.
14. Same as 1 , except W's letter stated that the price was to be effective until March 31, 1960. W mailed notice of a price change to be effective as of March 25, 1960. R mailed his order on March 26, 1960. The notice of price change arrived on March 27, 1960.
15. Same as 1 , except W's letter promised delivery within ten days after receipt of order. R's order requested guarantee of delivery by March 31, 1960. R's order was received by W on March 20, 1960.
16. Same as 1 , except W's letter provided terms of payment strictly cash. R's order provided for shipment C.O.D.
17. Same as 1 , except $R$ replied that he would not purchase any for more than $\$ 26.50$.
18. Same as 1 , except W's letter offered a special price of $\$ 27.00$ if twenty were ordered. R answered, "If I ordered fifty, what would be your price?" R later ordered twenty at $\$ 27$.
19. Same as 1 , except $R$ replied to W's letter, "I cannot accept your offer today. If I change my mind I shall be pleased to send you an order." A week later, R ordered ten bicycles at $\$ 27.50$.
20. Same as 1 , except R replied, "You may send ten at $\$ 27.50$, but I shall be happy to receive twenty at $\$ 27.00$." W's acceptance read, "I accept your order for ten at \$27.50."

## Number 2 (Estimated time- 15 to 25 minutes)

$\mathrm{W}, \mathrm{X}, \mathrm{Y}$ and Z entered into a written partnership agreement for a period of five years, commencing January 1, 1955. In the following series of situations you are to assume that a valid partnership has existed since that date, unless specific facts are expressed to the contrary.

You are to select from the alternative statements given for each situation all of those which express a correct conclusion to be drawn from the given state-
ment of facts according to the provisions of the Uniform Partnership Act. Caution: there may be more than one correct conclusion given in each instance.

Indicate your selection by placing an " $X$ " in the applicable column on an answer sheet. You will be penalized for each incorrect alternative you select.

1. The partnership will be dissolved without subjecting any of the partners to liability for damages to any other partner:
a. Upon the withdrawal of any partner at any time.
b. Upon the express written agreement of any three partners.
c. At the conclusion of a reasonable period for winding up its affairs after December 31, 1959.
d. At the conclusion of the actual winding up of its affairs after December 31, 1959.
e. None of the above.
2. $\mathrm{X}, \mathrm{Y}$ and Z could expel W from the partnership without incurring any liability for damages to W in the following circumstances:
a. In accordance with the express terms of the partnership agreement, without further cause.
b. Upon the unanimous written agreement of $\mathbf{X}, \mathbf{Y}$ and Z , without further cause.
c. Upon W's refusal to contribute his agreed share of the partnership capital.
d. Upon the unanimous written agreement of $\mathbf{X}, \mathbf{Y}$ and $\mathbf{Z}$, exercised in bad faith.
e. None of the above.
3. The partnership agreement provides that upon the death of a partner the firm shall not dissolve, but shall continue automatically with his executor as a substituted partner. W dies before the end of five years.
a. The firm does not dissolve but continues automatically with W's executor as a substituted partner.
b. The firm dissolves, and a new firm is created automatically with the executor as a new partner.
c. The firm dissolves, and must be completely liquidated.
d. The firm does not dissolve, but continues automatically with the three remaining partners.
e. None of the above.
4. Assume that W is a limited partner. The partnership will be dissolved automatically if:
a. W dies.
b. W assigns his interest in the partnership to a stranger.
c. W becomes active in the business.
d. The other partners use W's name and reputation to obtain business for the firm.
e. None of the above.
5. Assume that the five-year period is ended and the partners decide to liquidate. Proper notice is given to all parties, and W is granted authority by the other partners to wind up the affairs of the concern.
a. $\mathbf{X}, \mathbf{Y}$ and Z are relieved of all liability to creditors other than their remaining investment in the partnership.
b. X can bind $\mathrm{W}, \mathrm{Y}$ and Z in the course of winding up partnership affairs.
c. W can bind $\mathrm{X}, \mathrm{Y}$ and Z in connection with new business.
d. W can convey title to partnership real property.
e. None of the above.
6. The written partnership agreement provides that it shall last five years, unless earlier dissolved by agreement. No further explanation is given regarding the terms or procedure for accomplishing such dissolution. In order to avoid any liability for damages due to any partner from any other partner, such agreement to dissolve:
a. Must be unanimous.
b. A simple majority of the partners must agree.
c. One half of the partners may bring about the dissolution.
d. Any partner may bring about the dissolution.
e. None of the above.
7. Same facts as in number 6. Such agreement to dissolve:
a. Must be in writing.
b. May be oral.
c. May be evidenced by mere conduct.
d. Must be under the decree of a court.
e. None of the above.
8. A partner could obtain the decree of a court for the dissolution of the partnership if he could show that another partner:
a. Is of unsound mind.
b. Has overdrawn his account.
c. Has withheld funds belonging to the partnership, even though done in good faith.
d. Is consistently extravagant with partnership funds.
e. None of the above.
9. The written partnership agreement provides for a voluntary dissolution of the firm only under certain specified conditions. The partnership may be dissolved voluntarily without subjecting any of the partners to liability for damages to any other partner:
a. Only if in accordance with a decree of court.
b. If in strict accord with the express terms of the agreement.
c. Only if in substantial compliance with the terms of the agreement.
d. Unanimous agreement to dissolve regardless of conditions.
e. None of the above.
10. The partnership will be dissolved by:
a. The death of a creditor.
b. Bankruptcy of any partner.
c. Bankruptcy of the partnership.
d. Assignment of his interest by any partner.
e. None of the above.
11. The partners are co-owners of specific partnership property, holding title as:
a. Joint tenants.
b. Tenants by the entirety.
c. Tenants in partnership.
d. Sole tenants.
e. None of the above.
12. Upon assignment of any partner's interest in the firm, the assignee is entitled:
a. To participate in the management of the business.
b. To receive an annual accounting of the business.
c. Upon dissolution to receive his assignor's interest.
d. To inspect the books and records of the business.
e. None of the above.
13. Property would belong to W , rather than to the partnership, in the following circumstances if it had been:
a. Purchased with partnership funds, but title was recorded in the name of W .
b. Contributed as capital investment by W, but title remained in his name.
c. Purchased with partnership funds, and held for rental income, but not used in the regular partnership business, with title in the name of W .
d. Owned by W before organization of the partnership, and used by the firm in its regular business without payment of rent but without conveyance of title to partnership.
e. None of the above.
14. One of $X$ 's creditors has obtained a charging order on his interest in the firm. The creditor may have a receiver appointed with power:
a. To obtain X's share of the partnership profits.
b. To demand an accounting under any circumstances in which $\mathbf{X}$ could do so.
c. To assist in management of the business.
d. To examine the books and records of the partnership.
e. None of the above.
15. Same as number 14. The interest charged may be:
a. Redeemed by Y, with his separate property before foreclosure.
b. Redeemed with partnership property before foreclosure, but only with consent of all of the partners except X.
c. Purchased at the foreclosure sale with partnership funds, by any partner without consent of other partners.
d. Purchased at foreclosure sale with separate property, by any partner.
e. None of the above.
16. If $M$ were to enter the partnership, he would be liable for the debts of the firm at the date he entered:
a. As though M had been a partner when the debts were incurred.
b. Only to the extent that the debts are satisfied out of partnership property.
c. Only to the extent of M's original capital contribution.
d. Only to the extent that the old partners unanimously agree upon.
e. None of the above.
17. G would be considered to be a member of the firm if he were to receive a share of the net profits of the business:
a. As interest on a loan which is greater in amount than the capital contributions of $\mathrm{W}, \mathrm{X}, \mathrm{Y}$ or Z .
b. As payment for goodwill used in the business by the partnership.
c. As compensation for his services as a trusted confidential employee.
d. As the heir of a former partner, now deceased.
e. None of the above.
18. Notice to X of a matter concerning partnership business will not be deemed notice to the partnership or to the other partners:
a. If X is the partner acting for the partnership in the matter.
b. If X reasonably could or should have informed the partner acting for the partnership in the matter.
c. If X has received the notice within the course of partnership business.
d. If it concerns a fraud being committed upon the partnership by or with the consent of X.
e. None of the above.
19. All partners are liable for:
a. Ordinary debts and obligations of the partnership.
b. The torts of other partners committed in the course of partnership business.
c. The crimes of other partners committed in the course of partnership business.
d. Any penalty incurred as a result of the wrongful act of any partner in the course of partnership business.
e. None of the above.
20. In the absence of any agreement on the matter, a partner is entitled to interest:
a. On his entire capital contribution.
b. On that portion of his capital contribution which is in excess of his profitsharing ratio.
c. On that portion of his capital contribution which exceeds the amount agreed upon as his share.
d. On his entire capital contribution, if he is a limited partner.
e. None of the above.

## Number 3 (Estimated time- 15 to 25 minutes)

Jones Corporation has operated a department store for the past thirty years. Mr. Jones, its manager and sole stockholder, desires to retire from active participation in the business and has received overtures from Smith, Inc. regarding acquisition of the business. Four alternative methods have been proposed to accomplish this result, namely:
a. Mr. Jones will sell his stock to Smith, Inc. for cash and notes receivable.
b. Jones Corporation will sell its assets to Smith, Inc., which will assume all liabilities, giving cash and notes receivable for the difference.
c. Jones Corporation will merge into Smith, Inc.
d. Jones Corporation and Smith, Inc. will consolidate into a new company.
e. None of the methods.

You are to place an " X " in the appropriate column of your answer sheet for each of the following factual statements which apply to the parties involved after the completion of the transaction under the alternative methods proposed. Caution: some of the statements will not apply to any of the methods, in which event you should select item (e) "None of the Methods," while other statements will apply to more than one of the alternative methods. You are to select all correct alternatives. You will be penalized for each incorrect alternative you select.

1. Jones Corporation is dissolved.
2. Smith, Inc. is dissolved.
3. New Corporation is organized.
4. Mr. Jones owns Jones Corporation stock.
5. Mr. Jones owns Smith, Inc. stock.
6. Mr. Jones owns New Corporation stock.
7. Jones Corporation owns Smith, Inc. stock.
8. Jones Corporation owns New Corporation stock.
9. Smith, Inc. owns Jones Corporation stock.
10. Smith, Inc. owns New Corporation stock.
11. Jones Corporation owns assets formerly owned by Smith, Inc.
12. New Corporation owns assets formerly owned by Smith, Inc.
13. Smith, Inc. owns assets formerly owned by Jones Corporation.
14. New Corporation owns assets formerly owned by Jones Corporation.
15. Mr. Jones has no legal liability to creditors of the Jones Corporation as a result of the transaction.
16. Jones Corporation has no legal liability to creditors of Jones Corporation as a result of the transaction.
17. Smith, Inc. has no legal liability to creditors of Jones Corporation as a result of the transaction.
18. New Corporation has no legal liability to creditors of Jones Corporation as a result of the transaction.
19. New Corporation assumes liabilities of Smith, Inc.
20. Smith, Inc. assumes liabilities of Jones Corporation.

## Number 4 (Estimated time- 15 to 25 minutes)

In the following questions you are to assume, unless specifically indicated to the contrary, that the instrument is negotiable in form, complete and genuine on its face, properly delivered and correctly indorsed, that all signatures are genuine and that all acts performed by agents have been performed with due authorization, up to the time of the transaction being considered.

Indicate the correct statements by placing an " X " in each appropriate column on your answer sheet. Caution: there may be more than one correct statement for each question. You will be penalized for each incorrect alternative you select. If you feel there is a conflict of authority on the issue, choose answers which represent the majority position.

1. On a bill of exchange:
a. The party who is ordered to pay is the drawer.
b. The party who is primarily liable on the instrument after acceptance is the drawee.
c. When the bill has been accepted, the drawer becomes the acceptor.
d. When the bill has been indorsed, the drawer becomes the acceptor.
e. None of the above.
2. The following statements correctly and completely describe the indicated negotiable instrument:
a. A check is a bill of exchange drawn on a bank.
b. A check which is drawn on a bank by another bank is a bank draft.
c. A check which is drawn by a bank on itself is a certified check.
d. A cashier's check is a bank note which is payable on demand.
e. None of the above.
3. An instrument can be negotiated by mere delivery if:
a. It is payable to bearer on its face, and is not indorsed.
b. It is payable to order on its face, and is not indorsed.
c. It is payable to cash, and not indorsed.
d. It is payable to order on its face and the last indorsement is in blank.
e. None of the above.
4. A person (other than a payee) in possession of an instrument is a holder (as distinguished from a mere possessor, transferee, or a holder in due course) if he acquired ownership of the instrument by:
a. Negotiation of the instrument.
b. Novation of the instrument.
c. Assignment of the instrument.
d. Transfer of older instrument by purchase without indorsement.
e. None of the above.
5. $X$ received an unindorsed order instrument from the payee, for value. $X$ will be considered a holder of the instrument from the time:
a. The instrument was actually delivered to $\mathbf{X}$.
b. $X$ has paid full value, and the instrument was actually delivered to him.
c. $X$ indorsed the instrument.
d. $X$ exercises his right to have the payee indorse the instrument and it is indorsed.
e. None of the above.
6. In the following instances, indicate any in which a proper delivery of the instrument by the maker to the payee will be presumed:
a. A note payable to the order of $\mathbf{P}$ was found in the maker's safe deposit box after the maker's death.
b. A note payable to the order of $\mathbf{P}$ and $\mathbf{Q}$ was delivered to $\mathbf{Q}$.
c. A note payable to the order of $\mathbf{P}$ was given by the maker to $X$ with instructions to deliver it to $P$. The note is still held by $\mathbf{X}$.
d. A note payable to the order of $\mathbf{P}$ was found by a stranger and mailed to $\mathbf{P}$.
e. None of the above.
7. Assuming that a written side agreement not referred to in the note would prove the truth of the fact alleged, which of the following circumstances would be effective if used as a defense by the maker in a suit brought by a holder in due course?
a. An instrument payable to bearer was intended to be payable to order.
b. The payee agreed not to negotiate the instrument without the consent of the maker.
c. An instrument payable on demand was intended to be payable after 30 days.
d. The payee promised to renew the note, rather than demand payment.
e. None of the above.
8. Same facts as in 7, except that the side agreement was oral and that a holder has brought suit against the maker:
a. An agreement to pay the note only out of a particular fund.
b. An agreement that the collateral deposited with the note was to constitute the sole source of funds for payment.
c. An agreement that the note could be paid in installments.
d. An agreement that delivery of the instrument is to become effective only when a certain piece of property is sold. The property has not been sold.
e. None of the above.
9. If an instrument is wanting in any material particular, the following persons have prima facie authority to complete it by filling in the blanks:
a. Anyone in lawful possession.
b. A holder.
c. A bona fide purchaser.
d. The maker.
e. None of the above.
10. A holder of an instrument entered the incorrect amount in the proper blank space of an incomplete instrument. A subsequent holder in due course could recover that incorrect amount from:
a. The maker.
b. One who indorsed the instrument prior to the entry of the incorrect amount.
c. The holder who made the incorrect entry.
d. One who indorsed the instrument subsequent to the entry of the incorrect amount.
e. None of the above.
11. Same as 10 , except a subsequent holder is seeking recovery:
a. The maker.
b. The prior indorser.
c. The holder who made the incorrect entry.
d. The subsequent indorser.
e. None of the above.
12. Same as 10 , except a finder of the instrument is seeking recovery:
a. The maker.
b. The prior indorser.
c. The holder who made the incorrect entry.
d. The subsequent indorser.
e. None of the above.
13. The holder in due course of an instrument can recover from the maker even though:
a. The maker's signature on the instrument had been forged.
b. The instrument had been stolen from the maker after it was completed.
c. The instrument had been obtained by fraud in the execution.
d. The title of his transferor was actually defective because the payee's signature was forged.
e. None of the above.
14. The holder of an instrument wrote on the back above his signature, "I hereby assign all of my rights, title and interest to A." Such a writing would constitute:
a. A qualified indorsement.
b. A special indorsement.
c. A restrictive indorsement.
d. A mere assignment.
e. None of the above.
15. If an order instrument is indorsed in blank:
a. It may be negotiated without further indorsement.
b. The holder must indorse it before he may sue on the instrument.
c. The blank indorsement may be converted into a special indorsement by the holder.
d. The blank indorsement will prevent further indorsement of the instrument.
e. None of the above.
16. One who takes an order instrument for value without the indorsement of the payee:
a. Is a holder.
b. Has the right to have the indorsement of the transferor.
c. Has rights essentially similar to those of an assignee.
d. Cannot become a holder in due course.
e. None of the above.
17. One who indorses an instrument, "Payment guaranteed. Presentment for payment and notice of dishonor waived." is liable as:
a. Indorser only.
b. Guarantor only.
c. Indorser and guarantor.
d. Assignor only.
e. None of the above.
18. An instrument which is payable to bearer on its face has been indorsed specially.
a. The special indorser does not give the same warranties as a blank indorser.
b. It cannot be further negotiated.
c. The special indorser is liable only to his immediate indorsee.
d. The special indorser is liable to all subsequent holders in due course.
e. None of the above.
19. An instrument payable to order on its face is indorsed in blank and then specially.
a. It can be negotiated by delivery only.
b. It can be negotiated only if indorsed by the special indorsee.
c. It can be negotiated further.
d. A subsequent taker can become a holder in due course.
e. None of the above.
20. The indorsee of a restrictive indorsement may:
a. Receive payment from the maker.
b. Bring any action on the instrument that the indorser might bring.
c. Transfer his rights as indorsee where the form of the indorsement authorizes him to do so.
d. Strike out the restrictive indorsement and thus not be bound by it.
e. None of the above.

## Number 5 (Estimated time- 15 to 25 minutes)

Your client, The MFG Co., produces a wide variety of products and uses a number of different types of selling agencies in its marketing operations throughout the country. Among these agencies are the following:
a. Brokers
b. Commission merchants
c. Del credere agents
d. Distributors
e. Manufacturer's agents
f. Salesmen

You are to describe briefly in general terms the legal relationships between your client and each of the above types of agencies, taking into consideration, where significant: the duties of the agent; whether he is an employee or independent contractor; his power to bind his principal; whether he ordinarily has an inventory in his possession, and if so, who owns it; to whom your client will look for payment for merchandise sold; the means of compensating the agency; and any other factor which you feel is pertinent.

## Number 6 (Estimated time- 15 to 25 minutes)

a. X Co., a manufacturer of clothing, received a brochure from Y Co. extolling the virtues and describing in detail the specifications and results of laboratory tests regarding the strength, flexibility, resistance to strain, workability, and other attributes of various types of its plastic materials. Relying upon data contained in the brochure, X ordered a large quantity of one certain type of plastic material which was made into raincoats. To X's dismay, the material was wholly unsatisfactory for this purpose, as it had a definite tendency to tear under
ordinary use. $\mathbf{X}$ seeks to recover damages from $\mathbf{Y}$ for breach of warranty. Does X have a valid claim against Y? Apply the provisions of the appropriate Uniform Act which would be pertinent in arriving at your conclusion. Ignore any considerations of title or proof of damages which may be involved.
b. Suppose that instead of relying upon the data in the brochure, X had selected the type of material which it ordered, solely upon the basis of its own experiments with samples of material furnished by Y Co. Would your conclusions as to the claim against $\mathbf{Y}$ for breach of warranty be any different? Explain briefly.
c. Suppose that X Co . had not relied upon either the brochure or tests of samples, but had placed an order for "plastic material suitable for use in manufacturing raincoats." Would your conclusion as to the claim against $\mathbf{Y}$ for breach of warranty be any different? Explain briefly.

## Number 7 (Estimated time- 20 to 30 minutes)

a. $M$ operates a factory in which he manufactures sport shirts. His usual course of business is to have the customer furnish the cloth and patterns, while M furnishes the buttons, thread, linings, and other minor materials, in addition to performing all of the labor and machine work to make a completed garment.

1. Customer C delivered sufficient rare imported wool gabardine material to make up 1,000 dozen shirts for an exclusive trade. While the shirts were in process, a fire occurred in the building adjoining M's factory. The material was severely damaged by smoke and water, and there is no practical means of recovering damages from the persons at fault in causing the fire. Would M or C bear the burden of the damage done to the material? Apply the legal principles involved.
2. Customer D delivered sufficient standard broadcloth material for 10,000 dozen shirts. At the time of the fire $M$ was using part of this material to complete a rush order for Customer E, knowing that there would be no difficulty in replacing the broadcloth in time to complete the order for $\mathbf{D}$. Would M or D bear the burden of the damage done to the material? Apply the legal principles involved.
b. P owned a panel truck which he used to operate a parcel delivery service for several women's and children's low-priced specialty shops.
3. One day while he was making a delivery to an apartment house in the suburbs, a number of packages were stolen from the truck, which $\mathbf{P}$ had left unlocked. Would $\mathbf{P}$ bear the loss? Apply the legal principles involved.
4. Would your answer be any different if $\mathbf{P}$ had carefully placed a strong padlock on the truck door, which the thief had been obliged to break in order to steal the packages? Apply the legal principles involved.
5. Would your answer to part 2 be different if $\mathbf{P}$ had been engaged by an exclusive jewelry store rather than a group of specialty shops? Apply the legal principles involved.

## Number 8 (Estimated time-20 to 30 minutes)

a. An employee claims benefits under the workmen's compensation law of the state in which he is employed. His injury was sustained while he was attempting to adjust a loose belt on the lathe he was operating in the course of his employment.

1. The employer contests the claim on the grounds that the employee was grossly negligent inasmuch as he was adjusting the belt while the motor on the lathe was running. Should the employee recover? Apply the principles of law which are involved.
2. Suppose the employer contests the claim on the grounds that the employee was injured while deliberately disobeying strict instruction that the machine was not to be adjusted unless the motor was turned off. Should the employee recover? Apply the principles of law involved.
b. An employee claims benefits under the workmen's compensation act for injuries sustained when he fell from a scaffold while painting the front of his employer's store. The employer disputes the claim on the grounds that the employee was an independent contractor. What considerations will the employer use in attempting to establish that the injured person was an independent contractor rather than an employee?
c. An employee claims benefits under the workmen's compensation act for injuries sustained in an automobile accident while he was on his way to work.
3. Would he be entitled to recover? Apply the general rule of law which would govern the situation.
4. Would your answer be different if the accident occurred on the parking lot provided for employees on the grounds of the factory where he was employed? Explain briefly.

# EXAMINATION IN THEORY OF ACCOUNTS 

## May 20, 1960; 1:30 p.m. to 5:00 p.m.

## GROUP 1

## Answer all questions in this group.

## Number 1 (Estimated time- 25 to 35 minutes)

a. Stock dividends and stock split-ups are common forms of corporate stock distributions to stockholders.

Consider each of the numbered statements. You are to decide whether it:
A. Applies to both stock dividends and stock split-ups
B. Applies to neither
C. Applies to stock split-ups only
D. Applies to stock dividends only
(In each instance, the issuing company has only one class of stock.)

## Required:

On an answer sheet, print next to the number of each statement below, the single capital letter of the description which applies to the statement.

## Statements

1. There is no change in the total proprietary investment of the issuing corporation.
2. The individual stockholder's share of net assets is increased.
3. Subsequent per-share earnings, if any, are decreased.
4. The retained earnings available for dividends are increased.
5. The par (or stated value) of the stock is unchanged.
6. There is no transfer between retained earnings and capital stock accounts, other than to the extent occasioned by legal requirements.
7. Retained earnings in the amount of the distribution are transferred to capital stock, in some instances in an amount in excess of that required by the laws of the state of incorporation.
8. The total number of shares outstanding is increased.
9. The distribution is "income" to the individual stockholder for federal income tax purposes.
10. The distribution is a multiple as contrasted to a fraction of the number of shares previously outstanding.
b. On January 1, 1958, the Janetrude Corporation opened a manufacturing and selling branch in country X. All current transfers of funds are executed at the free market rate.

You are preparing a combined balance sheet and a combined earnings statement as of December 31, 1959, which is the end of the corporate year. Examine each of the numbered general ledger accounts of the foreign branch. Decide at which currency rate each should be converted.

## Currency Rates

E. The official rate of currency exchange at the date of payment, acquisition or entry
F. The official rate of currency exchange at December 31, 1959
G. The free market rate at the date of acquisition, entry or payment
H. The free market rate at December 31, 1959
I. An average rate of official currency exchange for 1959
J. The average free market rate for 1959 , or for each month of 1959

K: None of the above.

## Required:

On the answer sheet provided, print next to the number of each branch ledger account listed below the single capital letter of the currency rate at which the account should be converted in preparing combined statements:
11. Sales
12. Remittances from home office
13. Accounts receivable-trade
14. Office equipment (purchased in the United States and paid for in United States dollars)
15. Factory building
16. Inventory of finished goods-December 31, 1959 (use general rule)
17. Mortgage payable on factory building (due December 31, 1983)
18. Inventory of finished goods-January 1, 1959
19. Note payable to bank (due January 31, 1960)
20. Accumulated depreciation on factory building
c. You are analyzing the accounts of an executor of the estate of a decedent who died on January 17, 1960. Your examination of the will and other documents revealed that the decedent's son had been specifically bequeathed the decedent's only rental property, and bonds of the MT Corporation ( $\$ 100,000$ par value, 3\%, due February 28, 1975); the decedent's daughter was the beneficiary of a life insurance policy (face amount $\$ 150,000$ ) on which the decedent had paid the premiums; and his widow had been left the remainder of the estate in trust, with full powers of appointment.

Consider each of the numbered transactions. You are to decide whether each should be:
L. Allocated between Corpus (Principal) and Income
M. Allocated between Corpus (Principal) and Beneficiaries
N. Attributed solely to Income
O. Attributed solely to Corpus (Principal)
P. Attributed solely to Beneficiaries (or Devisees)

## Required:

On the answer sheet provided, print next to the number of each transaction below, the single capital letter of the treatment above which applies to the transaction.

## Transactions

21. January 20, 1960: $\$ 3,450$ was collected in connection with the redemption of AB Corporation bonds, 3\%, due January 15, 1960; par value \$3,000.
22. January 20, 1960: $\$ 1,000$ was collected from XY Corporation, on account of dividend of $\$ 1$ per share on common stock declared December 1, 1959, payable January 15, 1960 to stockholders of record January 2, 1960, ex-dividend December 30, 1959.
23. January 20, 1960: $\$ 3,250.50$ was paid to Smith \& Co., brokers, for the purchase of income bonds of A.A.R.R., $5 \%$, due June 30, 1972; face value $\$ 3,000$. The bonds trade flat.
24. January 21, 1960: 30 shares of common stock were received from the DQ Corporation, constituting receipt of an ordinary $3 \%$ common stock dividend declared December 14, 1959, payable January 20, 1960 to holders of record, January 15, 1960, ex-dividend January 10, 1960.
25. February 1, 1960: $\$ 400$ quarterly interest was paid on a promissory note due January 31, 1961.
26. February 1, 1960: Dr. Mathews, the decedent's physician, was paid $\$ 1,000$ for professional services rendered during the deceased's final illness. The executor elected to deduct this amount in the decedent's final income tax return.
27. February 1, 1960: $\$ 1,600$ was collected from TC Corporation, on account of a cash dividend of $\$ .50$ per share on common stock, declared January 18, 1960, payable January 30, 1960 to holders of record January 27, 1960, ex-dividend January 23, 1960.
28. February 1, 1960: $\$ 400$ rental income for February was deposited.
29. February 10, 1960: $\$ 500$ was paid for real estate taxes covering the period February 1 - July 31, 1960.
30. March 1, 1960: $\$ 1,572$ was paid on account of the decedent's state income tax for 1959.

## Number 2 (Estimated time-15 to 25 minutes)

The general ledger of Enter-tane, Inc., a corporation engaged in the development and production of television programs for commercial sponsorship, contains the following accounts before amortization at the end of the current year:

| Account | Balance (Debit) |
| :---: | :---: |
| Sealing Wax \& Kings | \$51,000 |
| The Messenger . . . . | 36,000 |
| The Desperado | 17,500 |
| Shin Bone | 8,000 |
| Studio Rearrangement | 5,000 |

An examination of contracts and records revealed the following information:

1. The first two accounts listed above represent the total cost of completed programs that were televised during the accounting period just ended. Under the terms of an existing contract Sealing Wax and Kings will be re-run during
the next accounting period, at a fee equal to $50 \%$ of the fee for the first televising of the program. The contract for the first run produced $\$ 300,000$ of revenue. The contract with the sponsor of The Messenger provides that he may, at his option, re-run the program during the next season at a fee of $75 \%$ of the fee on the first televising of the program.
2. The balance in The Desperado account is the cost of a new program which has just been completed and is being considered by several companies for commercial sponsorship.
3. The balance in the Shin Bone account represents the cost of a partially completed program for a projected series that has been abandoned.
4. The balance of the Studio Rearrangement account consists of payments made to a firm of engineers which prepared a report relative to the more efficient utilization of existing studio space and equipment.

## Required:

a. State the general principle (or principles) of accounting that are applicable to the first four accounts.
b. How would you report each of the first four accounts in the financial statements of Enter-tane, Inc. Explain.
c. In what way, if at all, does the Studio Rearrangement account differ from the first four? Explain.

## Number 3 (Estimated time- 20 to 30 minutes)

a. Distinguish between the meanings of a joint product and a by-product.
b. Describe and briefly discuss the appropriateness of two acceptable methods of accounting for the by-product in determination of the cost of the joint products.
c. Assuming proper treatment of the by-product costs, describe two acceptable methods of allocating to joint products the cost of the initial producing department.

## Number 4 (Estimated time- 20 to 30 minutes)

On June 1, 1957, the Knodd Corporation issued, at $98,61 / 2 \%$ bonds, face $\$ 500,000$, due May 30, 1977, interest payable semi-annually on June 1 and December 1. The expense of issue was $\$ 10,000$. The bonds were callable at $102 \frac{1}{2}$ on March 1, 1960, at which date they were retired out of the proceeds of new $4 \%$ bonds issued at 100 on February 1, 1960, face $\$ 600,000$, due February 1, 1980, interest payable semi-annually on February 1 and August 1. Knodd Corporation is on a calendar year basis and does not prepare monthly adjusting entries. Its income before taxes for 1959 was $\$ 75,000$, and is expected to be approximately that amount in 1960.

## Required:

a. List three accounting methods for treating the unamortized discount, issue expense and call premium on the $61 / 2 \%$ bonds at retirement, and explain the reasoning in support of each.
b. Using the method which conforms more closely than any other method to current accounting opinion, give the journal entry for the retirement of the $61 / 2 \%$ bonds.

## Number 5 (Estimated time-20 to 30 minutes)

a. What is the meaning of the term "contingencies" as used in accounting?
b. Distinguish between the accounting treatment accorded to a prospective gain as contrasted to a prospective loss arising from a contingency.
c. How should the following circumstances affect the presentation of the calendar-year-end statements of ABC Corporation? Explain.

1. Pending in a federal district court is a suit against $A B C$ Corporation. The suit, which asks for token damages, alleges that $A B C$ Corporation has infringed upon a 15 -year-old patent. Briefs will be heard on May 31 next.
2. The XYZ Union, sole bargaining agent of $A B C$ Corporation's production employees, has threatened a strike unless $A B C$ Corporation agrees to a proposed profit-sharing plan. Negotiations begin on August 1 next.
3. A recently completed (during the calendar year in question) government contract is subject to renegotiation. Although the ABC Corporation suspects that a refund of approximately $\$ 80,000$ may be required by the government, the company does not wish, for obvious reasons, to publicize this fact.
4. In the calendar year just ended, $A B C$ Corporation adopted a form of accelerated depreciation for federal income tax purposes. Its accounting records and financial statements still reflect straight-line depreciation.

## GROUP II

## Estimated time- $\mathbf{4 0}$ to $\mathbf{6 0}$ minutes

Answer only two questions in this group. If three are answered, only the first two will be considered.

## Number 6

The use of consolidated financial statements has become a common practice in published financial reports of American corporations. However, consolidated reports do not serve all of the purposes for which individual statements may be used.

## Required:

List and briefly discuss five limitations of the usefulness of consolidated reports.

## Number 7

The LMN Corporation has just acquired all of the capital stock of PQR Corporation and has asked you to audit the balance sheet of the latter as of date of acquisition. In the course of your examination you determine that the
company has a noncontributory pension plan and has charged to income all payments made to the pension trust. There is no special provision in the pension plan which limits the company liability to an amount equal to assets in trust. The independent actuaries employed by the company have furnished you with the following summary of past service liability as of the audit date.

|  | Accrued Liability | Assets <br> in Trust | Net Liability |
| :---: | :---: | :---: | :---: |
| For presently retired employees | \$1,189,000 | \$425,000 | \$ 764,000 |
| For employees eligible to retire at their own option | 477,000 | - | 477,000 |
| For employees under retirement age | 1,569,000 | - | 1,569,000 |
|  | \$3,235,000 | \$425,000 | \$2,810,000 |

## Required:

Discuss the factors to be considered in making adjustments to properly set forth the financial position disclosed by the statements under audit.

## Number 8

Tri-State Equipment Leasing Company leases equipment of all kinds to industrial users; most leases are for periods of from three to five years, during which time it is expected that the depreciable portion of the cost of such equipment and the necessary related financing charges will be recovered. Generally, the leases also contain purchase option clauses which permit the user to acquire the equipment at the estimated market price of the used equipment less a portion of estimated removal costs.

The company has followed the practice of charging a contracts receivable account and crediting an unearned rental income account for the gross contract rental at the time each lease is signed. The company finances a substantial portion of the cost of the rental equipment through installment loans which are secured by assignment of the lease rental contracts.

## Required:

Discuss the proper balance sheet presentation of the contracts receivable, leased equipment, unearned rental income, and installment loans payable accounts, giving your reasons for the method of presentation which you recommend. Note particularly the effect on working capital, total assets and total liabilities.

## EXAMINATION IN ACCOUNTING PRACTICE-PART I

November 2, 1960; 1:30 to 6:00 p.m.
(All problems are required.)

## Number 1 (Estimated time- 25 to 35 minutes)

Prior to January 1, 1959, ABC Company, a wholly-owned subsidiary of XYZ Company, conducted a business of importing hemp and fiber for resale purposes. As of January 1, 1959, ABC Company changed its business by entering into an agency agreement with the parent company whereby all transactions of ABC Company would be as agent for the purposes of purchasing and selling hemp and fiber for the account of XYZ Company as principal. The agreement provided, among other things, that ABC Company receive $\$ 1.80$ a ton for all hemp and fiber purchased for XYZ Company, including the beginning inventory.

During the course of your examination, you find that the books of account of ABC Company at December 31, 1959, the close of its business year, gave no effect to the agency agreement, and that certain of the accounts are as follows:


The beginning and ending inventories were priced (first-in, first-out basis, at cost which is not in excess of market) at $\$ 7.15$ and $\$ 7.20$ per hundred pounds, respectively. The average prices per hundred pounds for purchases (as recorded in the books of account after the adjustment for ending inventory) and sales were $\$ 7.18$ and $\$ 7.27$, respectively. During the year, payments of $\$ 50,000$, applicable to the settlement of the transfer of beginning inventory, were received from the XYZ Company which have been credited to Accounts Receivable.

## Required:

a. Journal entries as of December 31, 1959 to correct the books of account. (The books are not yet closed.)
b. Footnote to financial statements of $A B C$ Company, if any is deemed necessary in the circumstances.

## Number 2 (Estimated time- 15 to 20 minutes)

The Deep Hole Mining Co. started mining in the current year on certain land leased from T. Realty Company.

The royalty provisions in the lease are as follows:
a. Minimum annual royalty- $\$ 6,000$, with minimum of $\$ 1,500$ payable quarterly. Unearned minimum royalties may be recovered in any subsequent period from earned royalties in excess of minimum royalties. Minimum royalties of $\$ 18,000$ were paid for the three years prior to the current year.
b. Earned royalty- $\$ .10$ per ton shipped from the mine plus a per ton amount equal to $2 \%$ of the amount that the market value of the ore at the mine exceeds $\$ 4$ per ton.
Operations in the current year were as follows:

| Periods | Tons Shipped | PERTON |  |
| :---: | :---: | :---: | :---: |
|  |  | Market Value at Destination | Freight from Mine to Destination |
| 1st quarter | None | - | - |
| 2nd quarter | 100,000 | \$10.50 | \$3.10 |
| 3rd quarter | 200,000 | 10.00 | 3.20 |
| 4th quarter | None | - | - |
|  | 300,000 |  |  |

## Required:

Compute the amount of royalty to be paid to T. Realty Company for the current year and the amount of unearned minimum royalty at the end of the year.

## Number 3 (Estimated time- 25 to 35 minutes)

The Board of Directors of the ABC Corporation on December 1, 1959 declared a $2 \%$ stock dividend on the common stock of the corporation, payable on December 28, 1959 to the holders of record at the close of business December 15, 1959. They stipulated that cash dividends were to be paid in lieu of issuing any fractional shares. They also directed that the amount to be charged against Retained Earnings should be an amount equal to the market value of the stock on the record date multiplied by the total of (a) the number of shares issued as a stock dividend and (b) the number of shares upon which cash is paid in lieu of the issuance of fractional shares.

The following facts are given:

1. At the dividend record date-
(a) Shares of ABC common issued

2,771,600
(b) Shares of ABC common held in treasury 1,000
(c) Shares of ABC common included in (a) held by persons who will receive cash in lieu of fractional shares

202,500
(d) Shares of predecessor company stock which are exchangeable for ABC common at the rate of $11 / 4$ shares of ABC common for each share of predecessor company stock (necessary number of shares of ABC common have been reserved but not issued)
Provision was made for a cash dividend in lieu of fractional shares to holders of 240 of these 600 shares.
2. Values of $A B C$ common were:

Par value \$5
Market value at December 1st and 15th (Bid) 21
(Asked) 23
Book value at December 1st and 15th 16
Capital value at December 1st and 15th 10

## Required:

Entries and explanations necessary to record the payment of the dividend.

## Number 4 (Estimated time- 25 to 35 minutes)

Your new client has not prepared financial statements for three years since December 31, 1956. He used the accrual method of accounting and reported income on a calendar year basis prior to 1957. During the three years since December 31, 1956 his cash receipts and cash disbursements records were maintained and sales on account were entered, when made, directly into an accounts receivable ledger. However, no general ledger postings have been made since the December 31, 1956 closing.

Your examination has disclosed balances at the beginning and the end of the three-year period as follows:

|  | December 31, |  |
| :---: | :---: | :---: |
|  | 1956 | 1959 |
| Aging of accounts receivable- |  |  |
| Less than 1 year old | \$ 7,700 | \$14,100 |
| 1 to 2 years old | 600 | 900 |
| 2 to 3 years old |  | 400 |
| Over 3 years old |  | 1,100 |
| Total accounts receivable | \$8,300 | \$16,500 |
| Inventories | \$ 5,800 | \$ 9,400 |
| Accounts payable-merchandise purchases | \$ 2,500 | \$ 5,500 |

You have satisfied yourself as to the accuracy of the balances shown above.
Other information available to you is as follows:

|  | 1957 | 1958 | 1959 |
| :---: | :---: | :---: | :---: |
| Cash received on account- |  |  |  |
| Applied to- |  |  |  |
| Current years collections | \$74,400 | \$80,900 | \$104,400 |
| Accounts of the prior year | 6,700 | 7,500 | 8,400 |
| Accounts of two years prior | 300 | 200 | 1,000 |
| Total | \$81,400 | \$88,600 | \$113,800 |
| Cash sales | \$ 8,500 | \$13,000 | \$ 15,600 |
| Disbursements for merchandise purchases | \$62,500 | \$70,600 | \$ 86,900 |

No account balances have been written off as uncollectible during the threeyear period. The ratio of gross profit to sales remains constant from year to year.

## Required:

A schedule showing sales, cost of sales and gross profit for each of the years 1957, 1958 and 1959. Support the schedule with computations in good form.

## Number 5 (Estimated time- $\mathbf{4 0}$ to 60 minutes)

The Loading Company is planning to construct a two-unit facility for the loading of iron ore into ships. On or before January 1, 1961, the stockholders will invest $\$ 100,000$ in the company's capital stock to provide its initial working capital. To finance the construction program (the total planned cost of which is $\$ 1,800,000$ ), the company will obtain a commitment from a lending organization for a loan of $\$ 1,800,000$. This loan is to be secured by a ten-year mortgage note bearing interest at $5 \%$ per year on the unpaid balance. The principal amount of the loan is to be repaid in equal semiannual installments of $\$ 100,000$ beginning June 30, 1962.

Inasmuch as the proceeds of the loan will only be required as construction work progresses, the company has agreed to pay a commitment fee beginning January 1,1961 equal to $1 \%$ per year on the unused portion of the loan commitment. This fee is payable at the time amounts are "drawn-down," except at the time of the first "draw-down."

Work on the construction of the facility will commence in the fall of 1960. The first payment to the contractor will be due on January 1, 1961, at which time the commitment and loan agreement will become effective and the company will make its first "draw-down," for payment to the contractor, in the amount of $\$ 800,000$. As construction progresses, additional payments will be made to the contractors by "drawing-down" the remaining loan proceeds as follows (it is assumed that payment to the contractors will be made on the same dates as the loan proceeds are "drawn-down"):

| April 1, 1961 | $\$ 500,000$ |
| :--- | ---: |
| July 1, 1961 | 300,000 |
| December 31, 1961 | 100,000 |
| April 1, 1962 | 100,000 |

Because of weather conditions, the facility can operate only from April 1st through November 30th of each year. The construction program will permit the completion of the first of the two plant units (capable of handling $5,000,000$ tons) in time for its use during the 1961 shipping season. The second unit (capable of handling an additional $3,000,000$ tons) will be completed in time for the 1962 season. It is expected that $5,000,000$ tons will be handled by the facility during the 1961 season; thereafter, the tonnage handled is expected to increase in each subsequent year by 300,000 tons until a level of $6,500,000$ tons is reached.

The company's revenues will be derived by charging the consignees of the ore for its services at a fixed rate per ton loaded. Billing terms will be net, ten days. Based upon past experience with similar facilities elsewhere, it is expected that the Loading Company's operating profit should average $\$ .04$ per ton before charges for interest, finance charges, and depreciation of $\$ .03$ per ton.

## Required:

A cash forecast for each of three calendar years starting with 1961 to demonstrate the sufficiency of cash, to be obtained from (1) the sale of capital stock, (2) "draw-downs" on the loan, and (3) amount to be produced by the operating
facility, to cover payments to the contractor and on the debt principal and interest. Assuming a federal income tax rate of $52 \%$, compute the federal income taxes, if any, payable during the three-year period and/or the operating loss carry-over, if any, available to the corporation for the year beginning January 1, 1964. (For tax and accounting purposes, the commitment fee is to be charged in the year paid.)

## Number 6 (Estimated time- 60 to 85 minutes)

You have been engaged for advice on several details of J. W. Gore's personal federal income tax return for 1959. Your examination revealed the following information.

On May 1, 1957, B. W. Gore purchased an All-purpose Tractor Unit for $\$ 9,000$ and on October 1, 1958, gave this unit to his son, J. W. Gore, who used it in his business. The accumulated depreciation to date of gift was $\$ 1,500$. On the date of the gift the tractor unit had a fair market value of $\$ 7,000$. (No gift tax was incurred by B. W. Gore.)
J. W. Gore also used a truck in his business. His old truck was sold in December 1957. A truck was purchased new on January 1, 1958, at a cost of $\$ 5,400$, and J. W. Gore paid $\$ 1,000$ down, financing the balance with a chattel mortgage on the truck. J. W. Gore estimated that the tractor would have a five-year useful life and the truck a six-year useful life in his hands. He took the maximum depreciation allowed under the declining-balance method wherever possible and only used straight-line depreciation when he was not able to qualify an asset under the former method. He did not elect to use the $20 \%$ additional first-year depreciation. The method(s) used in depreciating the tractor and the truck for accounting purposes were the same as the allowable income tax method(s).

On October 1, 1959, J. W. Gore sold the all-purpose tractor for $\$ 4,800$ and purchased a new tractor assembly for $\$ 9,200$.

On July 1, 1959, J. W. Gore traded his truck for a new one which cost, and had a fair market value of, $\$ 4,500$. The dealer assumed the chattel mortgage after the principal had been reduced to $\$ 2,600$, and J. W. paid $\$ 2,000$ net cash difference on the deal.

On July 1, 1959, J. W. Gore was involved in an automobile accident. The automobile, which was purchased new on January 1, 1958 at a cost of $\$ 4,000$ with an estimated useful life of 5 years, was used by J. W. Gore $60 \%$ of the time for business. The value of the automobile was $\$ 2,200$ before the accident; it was completely destroyed.

On October 5, 1959, the insurance company paid J. W. Gore \$2,000. J. W. Gore purchased a new automobile at a cost of $\$ 4,200$; it is his desire to defer the recognition of any gain to the extent possible.
J. W. Gore learned that a $\$ 500$ personal loan he had made in 1957 became uncollectible in 1959. In addition to any capital gains and losses resulting from the above transactions, J. W. Gore had other long-term capital gains of $\$ 5,000$ from the sale of common stock, other short-term capital gains of $\$ 1,000$ from the sale of common stock, and a net capital loss carry-over of \$1,200 from 1958.
J. W. Gore has consistently filed his federal income tax return on a calendar year basis. Salvage value on trucks and tractors may be ignored.

## Required:

Compute the following in connection with J. W. Gore's 1959 federal income tax return:
a. With respect to the sale of the tractor:

1. The realized gain (or loss) for accounting purposes.
2. The recognized gain (or loss) for tax purposes.
3. The recognized gain (or loss) for tax purposes if the tractor had been sold for $\$ 6,500$.
4. The tax basis of the new tractor.
b. With respect to the trading of the truck:
5. The realized gain (or loss) for accounting purposes.
6. The recognized gain (or loss) for tax purposes.
7. The tax basis of the new truck.
c. With respect to the accident:
8. The recognized gain (or loss) for tax purposes on the automobile.
9. The tax basis of the new automobile.
d. Net capital gain (or loss).
e. Long-term capital gain deduction.
f. Casualty loss, if any, and/or business gain or loss from sales and exchanges of business assets arising from the listed transactions.

# EXAMINATION IN ACCOUNTING PRACTICE—PART II 

November 3, 1960; $1: 30$ to 6:00 p.m.

## GROUP I <br> (Solve all problems in this group.)

## Number 1 (Estimated time- $\mathbf{3 0}$ to $\mathbf{4 0}$ minutes)

The partners of Able, Bright, Cool and Dahl have decided to dissolve their partnership. They plan to sell the assets gradually in order to minimize losses. They share profits and losses as follows: Able, $40 \%$; Bright, $35 \%$; Cool, $15 \%$; and Dahl, $10 \%$. Presented below is the partnership's trial balance as of October 1,1960 , the date on which liquidation begins.

| , | Debit | Credit |
| :---: | :---: | :---: |
| Cash | \$ 200 |  |
| Receivables | 25,900 |  |
| Inventory, October 1, 1960 | 42,600 |  |
| Equipment (net) | 19,800 |  |
| Accounts payable |  | \$ 3,000 |
| Able, Loan |  | 6,000 |
| Bright, Loan |  | 10,000 |
| Able, Capital |  | 20,000 |
| Bright, Capital |  | 21,500 |
| Cool, Capital |  | 18,000 |
| Dahl, Capital |  | 10,000 |
|  | \$88,500 | \$88,500 |

## Required:

a. Prepare a statement as of October 1,1960 showing how cash will be distributed among partners by installments as it becomes available.
b. On October 31,1960 , cash of $\$ 12,700$ became available to creditors and partners. How should it be distributed?
c. If instead of being dissolved, the partnership continued operations and earned a profit of $\$ 23,625$, how should that profit be distributed if, in addition to the aforementioned profit sharing arrangement, it was provided that Dahl receive a bonus of $5 \%$ of the net income from operations after treating such bonus as an expense?

## Number 2 (Estimated time- $\mathbf{3 0}$ to $\mathbf{4 0}$ minutes)

You are engaged to audit the accounts of XYZ, Inc. Following is an analysis of the retained earnings account of XYZ, Inc. for the year ended December 31, 1959:

| Balance at January 1, 1959 | \$1,000,000 |
| :---: | :---: |
| Net income for the year | 70,000 |
| Loss on sale of land used in the business | $(25,000)$ |
| Dividends paid on preferred stock | $(20,000)$ |
| Amount appropriated for general contingencies | $(10,000)$ |
| Balance at December 31, 1959 | \$1,015,000 |

Your audit and review of the income and expense accounts for the year reveal the following information:

1. Interest on $\$ 500$ on City of $\mathbf{X}$ bonds was received during the year.
2. Insurance expense includes premiums of $\$ 800$ paid for insurance on the life of an officer, the corporation being the beneficiary of the policy. The year's increase of $\$ 600$ in the cash surrender value of the policy was credited to this account, leaving a net expense of $\$ 200$.
3. Included in the net income for the year was a net gain of $\$ 1,500$ on the sale of the following assets:

|  | Gain or (loss) |
| :---: | :---: |
| Factory equipment (depreciable assets) | \$ 4,000 |
| City of X bonds | $(1,500)$ |
| U.S. Government bonds | $(1,000)$ |
| Net gain | \$ 1,500 |

Except for the U.S. Government bonds, the assets had been held for at least 6 months at date of sale.
4. The provision for federal income taxes was $\$ 40,000$. Interest of $\$ 300$ paid on a federal tax deficiency was charged against the liability for federal income taxes recorded in the accounts.
5. Depreciation expense includes $\$ 1,800$ on an emergency facility acquired under a certificate of necessity. This amount was computed on the basis of the useful life of the asset to the corporation, whereas the amount allowable under the certificate, $\$ 5,000$, will be claimed as a tax deduction.
6. Original organization expenses incurred on January 1, 1946, $\$ 1,000$, were written off to income in 1959.
7. Miscellaneous income and expense was composed of the following items:

Income or (expense)
Adjustment of property accounts resulting from the capitalization of
certain repairs by the revenue agent for the year 1956 (Note 1) $\$ 4,000$

Broker's commission paid for sale of land ................... $\begin{aligned} & \mathbf{( 1 , 0 0 0 )}\end{aligned} \$$| $\$ 3,000$ |
| :--- |

(Note 1): The company's federal income tax returns for the years 1955 through 1958 were examined in 1959 by a revenue agent, and $\$ 10,000$ of repairs deducted as an expense in the return for 1956 was capitalized by the revenue agent. Allowable depreciation thereon through 1958 was $\$ 6,000$. Proper depreciation on these items was recorded in the accounts for the year ended December 31, 1959.
8. A contribution of $\$ 10,000$ was paid to the City of $X$ community chest.
9. The land was sold on July 1, 1959 and had been owned for over 5 years on that date. This land was used, until it was sold, for storage of company dies and patterns.

## Required:

Prepare a schedule showing computation of taxable income for XYZ, Inc. for the year 1959. All supporting computations should be shown in good form.

## Number 3 (Estimated time- 50 to 70 minutes)

On January 10, 1960, The Radot Corporation engages you to adjust the books and prepare a balance sheet at December 31, 1959 that will conform with generally accepted accounting principles. You begin by preparing the following trial balance as of December 31, 1959 from the general ledger.

| Cash | \$ 16,000 |  |
| :---: | :---: | :---: |
| Accounts receivable | 17,000 |  |
| Allowance for bad debts |  | \$ 3,000 |
| Inventories | 10,000 |  |
| Investments | 17,000 |  |
| Fixed assets | 148,000 |  |
| Accumulated depreciation |  | 5,000 |
| Accounts payable |  | 6,000 |
| Notes payable |  | 14,000 |
| Capital stock |  | 75,000 |
| Retained earnings |  | 105,000 |
|  | \$208,000 | \$208,000 |

Subsequent examination discloses the following:

## 1. Cash

a. The bank letter of confirmation shows a cash balance of $\$ 16,000$ at December 31, 1959.
b. Examination of returned checks received with the January 15, 1960 cutoff statement reveals $\$ 3,000$ of checks dated December 31, 1959. The checks were for unrecorded 1959 expenses.
c. The cash deposits made December 31, 1959 for $\$ 1,700$ and January 2, 1960 for $\$ 900$ were both recorded by the bank on January 3, 1960. The deposits were for unrecorded cash sales.
d. One of the checks returned January 15, 1960, dated December 31, 1959 for $\$ 300$ for a 1959 expense was actually not written until January 3, 1960; the check was recorded as of December 31, 1959.

## 2. Accounts receivable

Analysis of accounts receivable reveals that with two exceptions all appeared collectible at December 31, 1959.
a. The Ambrosia Butane Distributors had fallen into receivership and were expected to realize only $\$ .40$ on the dollar. The December 31, 1959 balance was $\$ 5,000$. On February 17, 1960, $\$ 4,000$ was recovered.
b. The Wimberly Mercantile Association had not paid anything on their balance of $\$ 3,000$ and this account was written off as uncollectible since Albert Wimberly, president of the Association, had informed your client in December, 1959 that it appeared impossible that current obligations could ever be met and that mortgage holders would probably absorb all asset proceeds in the event of liquidation. However, on March 2, 1960, ten days before issuance of your report, $\$ 1,500$ was received as final settlement on this account.

## 3. Allowance for bad debts

The $\$ 3,000$ balance is the amount expected to absorb the loss on The Ambrosia Butane Distributors account.

## 4. Inventories

a. Inventory in the amount of $\$ 9,000$ is priced at net realizable value (regular sales price less marketing costs).
b. Current cost of replacement of inventory mentioned in (a) above is $\$ 7,000$.
c. Estimated marketing costs are $10 \%$ of sales price.
d. Goods are priced to return a $40 \%$ gross profit based on sales.
e. Inventory in amount of $\$ 1,000$ represents goods received on a consignment basis for which a liability has been recorded. These goods were priced at cost.

## 5. Investments

a. $\$ 5,000$ of the balance represents the cost of 1,000 shares of the Xelo Corporation, an unconsolidated subsidiary. Market value of these shares at December 31, 1959 was $\$ 1,700$. The market is not expected to recover in the foreseeable future.
b. $\$ 1,000$ represents the cost of Brentlow, Incorporated bonds due August 1, 1979. Interest is payable February 1 and August 1 at $6 \%$. The bonds were purchased at par, but would sell on the open market for $\$ 1,040$.
c. The remaining $\$ 11,000$ represents the cost of temporary investments. Market value at December 31 was $\$ 10,400$.
6. Fixed assets

The balance in this account represents the cost of various equipment which was purchased at date of incorporation, January 1, 1958. One truck costing $\$ 6,000$ was sold for $\$ 5,000$ December 31, 1959, the proceeds being credited to accumulated depreciation.

## 7. Accumulated depreciation

a. No entries have been made in this account except for the $\$ 5,000$ realized from the sale of equipment.
b. Equipment when purchased was expected to have a 10 -year life, with a $10 \%$ salvage value.
c. You agree with the client to set up depreciation on a straight-line basis for book purposes and on a declining-balance method for federal income tax purposes. Proper depreciation was taken for tax purposes the previous year on a declining-balance method.
8. Accounts payable

The entire account of $\$ 6,000$ is due to one creditor for consigned merchandise, $\$ 1,000$ of which is still on hand.
9. Notes payable

The following is a trial balance of notes payable (interest payable semiannually on exact due dates):

| Creditor | Date of Note | Interest Rate | Due Date | Amount |
| :---: | :---: | :---: | :---: | :---: |
| Brumalow and Breichour, Ltd. | 1/1/59 | 6\% | 1/1/60 | \$ 5,000 |
| Lawson Hickey, Incorporated | 6/30/59 | 5\% | , | 4,000 |
| Daniel Duncan | 6/30/58 | 5\% | 6/30/60 | 5,000 |
|  |  |  |  | \$14,000 |

${ }^{*}$ Principal payable in semiannual installments of $\$ 2,000$ beginning December 31, 1960.

## 10. Capital stock

The following analysis was obtained:
Balance, January 1, 1959 ( 1,000 shares @ $\$ 100$ par) ......... $\$ 100,000$
Deduct repurchase of 250 shares, still in treasury ............. 25,000
Balance, December 31, 1959 .................................. $\$ \overline{\$ 75,000}$

## 11. Retained earnings

The following is an analysis of retained earnings since date of incorporation, per client's records:

| Date | Explanation | Amount |
| :---: | :---: | :---: |
| 1/1/58 | Premium on stock sold (1,000 shares) | \$ 10,000 |
| 12/31/58 | Net loss for year | $(15,000)$ |
| 12/31/59 | Loss on purchase of treasury stock | $(2,000)$ |
| 12/31/59 | Net income for year | 112,000 |
|  | Balance, December 31, 1959 | \$105,000 |

12. You estimate the accrued federal income tax as of December 31, 1959 to be \$17,043.40.

## Required:

Prepare a worksheet showing account balances per books, any adjustments you consider necessary, and adjusted balances. Also, indicate which balances you would consider to be current, which balances noncurrent, and which balances would be shown in the stockholders' equity section of the balance sheet. Prepare schedules of inventories, depreciation, and deferred taxes in good form. (Note: It is not necessary to prepare a formal balance sheet or journal entries for any adjustments you determine.)

## GROUP II <br> (Estimated time- $\mathbf{8 0}$ to $\mathbf{1 2 0}$ minutes.)

(Solve only two problems in this group. If three are solved, only the first two will be considered.)

## Number 4

The Johnson Appliance Company started business on January 1, 1959. Separate accounts were established for installment and cash sales, but no perpetual inventory record was maintained.

On installment sales, the price was $106 \%$ of the cash sale price. A standard installment contract was used whereby a down-payment of one-fourth of the installment price was required, with the balance payable in 15 equal monthly installments. (The interest charge per month is $1 \%$ of the unpaid cash sale price equivalent at each installment.)

Installments receivable and installment sales were recorded at the contract price. When contracts were defaulted the unpaid balances were charged to bad debt expense. Sales of default merchandise were credited to bad debt expense.

## Sales:

Cash sales
\$126,000

Installment sales
265,000
Repossessed sales . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 230
Inventory, January 1, 1959:
Merchandise inventory 58,060

## Purchases, 1959:

New merchandise . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 209,300
Inventories, Physical, December 31, 1959:
New merchandise . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 33,300
Repossessed inventory . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 180
Cash Collections on Installment Contracts, 1959:
Down payments . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 6 . 6 ,250
Subsequent installments . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 79,341
(average 6 monthly installments on all contracts except on defaulted contracts)
Five contracts totaling $\$ 1,060$ were defaulted, in each case after three monthly installments were paid.

Interest should be recognized in the period earned.

## Required:

a. The gross profit percentage for 1959 .
b. A schedule showing, by payment for the first seven months: the cash sale price equivalent, the contract balance, the amount of interest earned, and the cash collected on a $\$ 1,060$ installment sale contract.
c. The net gain or loss on defaulted contracts during 1959.
d. The realized gross profit for 1959.

## Number 5

You are engaged in an audit of the ABC Manufacturing Company's financial statements as of December 31, 1959, and are in the process of verifying the pricing of the company's inventory of work in process and finished goods which is recorded on the company's books as follows:

> | Finished goods inventory, 110,000 units $\ldots \ldots . . . . . . . . . . . . . . . . ~$ |
| :--- |
| Work-in-process inventory, 90,000 units, $50 \%$ completed . . . . . 330,900 |
| 380 |

The company follows the practice of pricing the above inventories at the lower of cost or market on a first-in, first-out method. You learn that materials are added
to the production line at the start of the process, and that overhead is applied to the product at the rate of $75 \%$ based on direct labor dollars. You also learn that the market value of the finished goods inventory and the work in process inventory is greater than the amounts shown above, with the exception of the defective units in the ending inventory of finished goods, the market value of which amounts to $\$ 1.00$ per unit.

A review of the company's cost records shows the following information:


You also learn that the defective units occur at the end of the process, i.e., units are found to be defective at the point of final inspection.

## Required:

a. Schedules indicating:

1. Effective or equivalent production.
2. Unit costs of production of materials, labor and overhead.
3. Pricing of inventories of finished goods, defective units, and work-in-process.
b. The necessary journal entry(ies), if any, to correctly state inventory valuation of finished goods and work-in-process. (Ignore income tax considerations.)

## Number 6

The City of Larkspur provides electric energy for its citizens through an operating department. All transactions of the Electric Department are recorded in a self-sustaining fund supported by revenue from the sales of energy. Plant expansion is financed by the issuance of bonds which are repaid out of revenues.

All cash of the Electric Department is held by the City Treasurer. Receipts from customers and others are deposited in the Treasurer's account. Disbursements are made by drawing warrants on the Treasurer.

The following is the post closing trial balance of the Department as at June 30, 1959:

Cash on deposit with City Treasurer . . . . . . . . . . . . \$ 2,250,000
Due from customers . . . . . . . . . . . . . . . . . . . . . . . . 2, 2, 120,000
Other current assets . . . . . . . . . . . . . . . . . . . . . . . . . 130,000
Construction in progress . . . . . . . . . . . . . . . . . . . $\quad 500,000$
Land . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 5,000,000
Electric plant . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 50,000,000*
Accumulated depreciation-electric plant ...... . $\$ 10,000,000$
Accounts payable and accrued liabilities ....... $\quad \mathbf{3 , 2 7 0 , 0 0 0}$
$5 \%$ electric revenue bonds . . . . . . . . . . . . . . . . . . . . $20,000,000$
Accumulated earnings . . . . . . . . . . . . . . . . . . . . . . . . $\overline{\$ 60,000,000} \stackrel{\text { 26,730,000 }}{\underline{\$ 60,000,000}}$
*The plant is being depreciated on the basis of a 50 year composite life.
During the year ended June 30, 1960 the Department had the following transactions:

1. Sales of electric energy - $\$ 10,700,000$.
2. Purchases of fuel and operating supplies - $\$ 2,950,000$.
3. Construction of miscellaneous system improvements (financed from operations) - \$750,000.
4. Fuel consumed - $\$ 2,790,000$.
5. Miscellaneous plant additions and improvements placed in service $\$ 1,000,000$.
6. Wages and salaries paid - $\$ 4,280,000$.
7. Sale on December 31, 1959 of 20 year $5 \%$ Electric Revenue bonds, with interest payable semiannually - $\$ 5,000,000$.
8. Expenditures out of bond proceeds for construction of Larkspur Steam Plant Unit No. 1 and control house - $\$ 2,800,000$.
9. Operating materials and supplies consumed - $\$ 150,000$.
10. Payments received from customers - $\$ 10,500,000$.
11. Expenditures out of bond proceeds for construction of Larkspur Steam Plant Unit No. 2 - $\$ 2,200,000$.
12. Warrants drawn on City Treasurer in settlement of accounts payable $\$ 3,045,000$.
13. Larkspur Steam Plant placed in service June 30, 1960.

## Required:

A worksheet for the Revenue Fund of the Electric Department showing:

1. The balance sheet amounts at June 30, 1959.
2. The transactions for the year. (Note: Journal entries supporting your transactions are not required.)
3. The balance sheet amounts at June 30, 1960.
4. The sources and applications of funds during the year.

## EXAMINATION IN AUDITING <br> November 3, 1960; 8:30 a.m. to $12: 00 \mathrm{~m}$. <br> (All questions are required.)

## Number 1 (Estimated time- 15 to 20 minutes)

In connection with your audit, you request that the management furnish you with a letter or letters containing certain representations. For example, such representations might include the following: (1) the client has satisfactory title to all assets, (2) no contingent or unrecorded liabilities exist except as disclosed in the letter, (3) no shares of the company's stock are reserved for options, warrants or other rights, and (4) the company is not obligated to repurchase any of its outstanding shares under any circumstances.

## Required:

a. Explain why you believe a letter of representation should be furnished to you. (Do not discuss the content of the letter.)
b. In what way, if any, do client representations affect your audit procedures and responsibilities?

## Number 2 (Estimated time- 25 to 35 minutes)

Your client, Star Wholesale Co., is a wholesaler selling merchandise to local hardware and paint stores. The Coaton Paint Co. has sold its outdoor paint products to Star Wholesale Co. for years on regular terms. Recently the Coaton Paint Co. developed a new line of indoor paint and, to introduce the paint, offered it to distributors on a consignment basis.

In your preliminary work prior to the annual physical inventory, you determine that a proper consignment contract had been signed but the accounting department had not been advised of it. Invoices for consigned merchandise were paid when submitted without regard for the consignment feature. Consigned merchandise was not set aside in the warehouse. Under the consignment contract, Star Wholesale Co. was supposed to remit monthly for paint sold.

## Required:

a. What audit procedures would you recommend for verifying the consigned stock?
b. What adjustments of balance sheet accounts, if any, might be required?
c. The discovery that the accounting department had not been advised of the consignment contract is an indication of weakness in internal control. What procedures of the company should be reviewed for possible expansion or other changes?

## Number 3 (Estimated time- $\mathbf{1 5}$ to 25 minutes)

In most medium-sized and large audits, it is customary for the auditor to select for detailed examination a series of items entered in the voucher register. The selection is from a period other than at year end.

## Required:

a. What are the objectives or purposes of the vouching test?
b. Name the items for which each voucher is to be examined by the auditor performing this test.

## Number 4 (Estimated time- 20 to 30 minutes)

Public accounting firms often develop and use a questionnaire to investigate and record their inquiries into the client's internal control system in order to determine whether there are weaknesses in internal control.

## Required:

Prepare an internal control questionnaire pertaining to securities (short-term and long-term investments) held by a medium-sized manufacturing company.

## Number 5 (Estimated time- 25 to 35 minutes)

XYZ operates sales divisions in several cities throughout the country. In addition to other activities the sales divisions are charged with the collection of local receivables; each division maintains a bank account in which all collections are deposited intact. Twice a week these collections are transferred to the home office by check; no other checks are drawn on this bank account. Except for cash receipts and cash disbursements books no accounting books are kept at the sales offices, but all cash records are retained by them in their files.

As part of your year-end audit you wish to include an audit of cash transfers between the sales divisions and the main office. It is intended that your representative will visit all locations.

## Required:

a. What are the purposes of the audit of cash transfers?
b. Assuming that your representative has a full knowledge of audit procedures for regular cash collection to which he will attend at each location, design only such additional specific audit steps as he will be required to perform to audit the cash transfers from each sales division to home office.

## Number 6 (Estimated time- 25 to 35 minutes)

Races Corporation acquired a large tract of land in a small town approximately 10 miles from Capital City. The company executed a firm contract on November 15, 1958 for the construction of a one-mile race track, together with related facilities. The track and facilities were completed December 15, 1959. On December 31,1959 a $6 \%$ installment note of $\$ 100,000$ was issued along with other
consideration in settlement of the construction contract. Installments of $\$ 50,000$ fall due on December 31 of each of the next two years. The company planned to pay the notes from cash received from operations and from sale of additional capital stock.

The company adopted the double declining-balance method of computing depreciation. No depreciation was taken in 1959 because all racing equipment was received in December after the completion of the track and facilities.

The land on which the racing circuit was constructed was acquired at various dates for a total of $\$ 43,000$, and its approximate market value on December 31, 1959 is $\$ 60,000$.

Through the sale of tickets to spectators, parking fees, concession income and income from betting, the company officials anticipated that approximately $\$ 175,000$ would be taken in during the typical year's racing season. Cash expenses for a racing season were estimated at $\$ 123,000$.

You have made an examination of the financial condition (balance sheet audit) of Races Corporation as of December 31, 1959. The balance sheet as of that date and statement of operations follow.

## Races Corporation <br> BALANCE SHEET <br> December 31, 1959

| Assets |  |  |
| :---: | :---: | :---: |
| CASH |  | \$ 14,500 |
| ACCOUNTS RECEIVABLE |  | 1,000 |
| PREPAID EXPENSES |  | 7,500 |
| PROPERTY (at cost) : |  |  |
| Land | \$ 43,000 |  |
| Grading and track improvements | 68,200 |  |
| Grandstand . . . . . . . . . . . . . . | 100,000 |  |
| Buildings | 60,000 |  |
| Racing equipment | 40,000 | 311,200 |
| ORGANIZATION COSTS |  | 300 |
| TOTAL ASSETS |  | \$334,500 |
| Liabilities and Stockholders' Equity |  |  |
| ACCOUNTS PAYABLE |  | \$ 22,000 |
| INSTALLMENT NOTE PAYABLE-6\% |  | 100,000 |
| STOCKHOLDERS' EQUITY: |  |  |
| Capital stock, par value $\$ 1$ per share, authorized 200,000 , issued and outstanding 47,800 shares |  | 47,800 |
| Capital in excess of par, representing amounts paid in over par value of capital stock |  | 174,700 |
| Retained earnings (deficit) |  | $(10,000)$ |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY |  | \$334,500 |

## Races Corporation STATEMENT OF OPERATIONS

For the Period from Inception, December 1, 1956

to December 31, 1959

| INCOME |  |
| :---: | :---: |
| Profit on sales of land | \$ 5,000 |
| Other | 100 |
|  | 5,100 |
| GENERAL AND ADMINISTRATIVE EXPENSES | 15,100 |
| Net loss for the period | \$10,000 |

On January 15, 1960 legislation which declared betting to be illegal was enacted by the state legislature and was signed by the governor. A discussion with management on January 17 about the effect of the legislation revealed that it is now estimated that revenue will be reduced to approximately $\$ 48,000$ and cash expenses will be reduced to one-third the original estimate.

## Required (Disregard federal income tax implications):

a. The explanatory notes to accompany the balance sheet.
b. The most comprehensive auditor's opinion covering the balance sheet. The scope paragraph should be omitted and the opinion dated February 1, 1960.
c. If the report is in any way qualified as to opinion, give an explanation of your reasons for the qualification.

## Number 7 (Estimated time- 20 to 30 minutes)

You have found from past experience that a number of your clients carry either a coinsurance type or the reporting type contents fire insurance. Frequently they have found upon the occurrence of a loss that they suffered a larger loss than expected because of being underinsured.

## Required:

a. Explain and illustrate the difference between a $90 \%$ coinsurance contents fire policy and a reporting type contents fire policy.
b. Prepare a list of items that cause underinsurance on a contents policy insuring against losses from fire.

# EXAMINATION IN COMMERCIAL LAW <br> November 4, 1960; 8:30 a.m. to 12:00 m. <br> <br> GROUP I <br> <br> GROUP I <br> (Answer all questions in this group.) 

## Number 1 (Estimated time- 20 to 30 minutes)

You are to select all of those phrases which state a correct legal conclusion based on general principles of law and provisions of the Uniform Partnership Act. Indicate your selection by placing an " X " in the appropriate column provided on the answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select the correct answers will be penalized.

In the following questions (1-5) assume that J has operated the J Construction Co. as a single proprietorship, building roads and performing related activities.

1. J and K desire to become partners in the business. This would be possible under ordinary circumstances even though $K$ were:
a. A corporation.
b. Another partnership.
c. A minor.
d. A married woman.
e. An alien.
2. A creditor would be justified in assuming that $\mathbf{F}$ (an employee) and J were partners in the J Construction Co. in the following situations:
a. F receives as a bonus each year a percentage of the annual net profits of J Construction Co.
b. F's sole compensation is a percentage of the annual net profits of J Construction Co.
c. F receives a percentage of the gross receipts from all business which he brings into J Construction Co.
d. F receives a percentage of the net profits from all business which he brings into J Construction Co.
e. None of the above.
3. A creditor would be justified in assuming that $G$ and $J$ were partners in the J Construction Co. in the following situations:
a. G and J are joint owners of the building in which J Construction Co. has its offices.
b. G and $\mathbf{J}$ are joint owners of some of the equipment used on certain construction jobs.
c. G received a share of the profits from jobs on which his personally owned equipment was used.
d. G received a share of the gross proceeds from jobs on which his personally owned equipment was used.
e. None of the above.
4. C could bind J as F's partner for an act done by F, even though no actual partnership existed, if any of the following events occurred:
a. J told C that F was his partner.
b. F told C that J was his partner.
c. $\mathbf{F}$ told $\mathbf{C}$, in the presence of J , that he and J were partners.
d. X told C that F and J were partners.
e. None of the above.
5. C could bind J as F's partner for an act done by $F$, even though no actual partnership exists, if C contends that J stated that J and F were partners and any of the following events occurred:
a. The statement was made after C had entered the transaction with F .
b. C had dealt solely with F on several occasions subsequent to the statement that F and J were partners.
c. J had actually told $\mathbf{C}$ that he would like to have F as a partner.
d. J had actually told $\mathbf{C}$ that F was going to be his partner.
e. None of the above.

Assume in the following questions (6-15) that $K$ and $L$ have joined $J$ as partners in the J Paper Products Sales Co. The partners have agreed that the express approval of at least two partners is required for all dispositions of partnership assets, other than those sold in the ordinary course of business, for all loans made to or by the firm, and for all expenditures which exceed $\$ 250$.
6. J signed a 90 -day negotiable note with a bank in the name of the partnership but without the consent of K or L . The bank did not investigate J's authority but could nevertheless recover from the firm if:
a. The partnership had paid such notes in the past.
b. The note was given in payment for packaging equipment purchased for the partnership.
c. The agreement among the partners is included in the Articles of Partnership.
d. Same as $c$, except the agreement among the partners is merely oral.
e. None of the above.
7. J signed a 90 -day negotiable note with a bank in the name of the partnership but without the consent of K or L. The bank did not investigate J's authority but could nevertheless recover from the firm if:
a. The proceeds were deposited in J's personal account with the bank.
b. K and L had notified the bank that they would not be responsible for notes unless signed by two partners.
c. J, K and L were attorneys in a law partnership and not in the paper products business.
d. The proceeds were used to pay current partnership obligations.
e. None of the above.
8. The partnership will be bound if J , without the consent of K and L , should sign an employment contract with $\mathbf{F}$ to act as foreman for the firm and:
a. F relied solely on the authority of J without any investigation whatsoever.
b. F had previously been rejected as a prospective employee by $K$ and $L$.
c. $\mathbf{F}$ knew that K and L had offered the same position to H , who had not made a decision.
d. F knew of the agreement requiring consent of at least two partners.
e. None of the above.
9. The partnership will be bound by J's act if $J$, without the consent of $K$ and L, should:
a. Order stationery and office supplies as needed; the order exceeded $\$ 250$.
b. Cancel liability insurance.
c. Write a partnership check to a firm creditor for more than $\$ 250$.
d. Lease building to be used as an office for the firm for $\$ 300$ per month.
e. None of the above.
10. The partnership will be bound by J's act if J, without the consent of $K$ and L, should:
a. Sell ten company automobiles.
b. Sell a building used as a storage place for the firm's products.
c. Purchase a new company automobile for cash.
d. Purchase a new company automobile on credit, giving a chattel mortgage for purchase price.
e. None of the above.
11. The partnership will be bound by J's act if J , without the consent of K and $L$, should:
a. Endorse the name of partnership on a note of $F$, the foreman, as an accommodation for the purchase of F's personal auto.
b. Endorse name of partnership on his own note for purchase of his own personal auto.
c. Hire an attorney to prosecute a case for the firm.
d. Authorize the firm's attorney to confess a judgment against the firm.
e. None of the above.
12. K and L enter into the following transactions on behalf of the partnership. J will be held liable as a partner even though he objects promptly and tells K and L that he will not be bound by the action.
a. Prosecution of a lawsuit involving partnership business.
b. Purchase of land as an investment in the hope that the land will increase in value.
c. Enter a contract to combine with another partnership.
d. Purchase of land on which to build a shop and garage for the firm.
e. None of the above.
13. $K$ and $L$ enter into the following transactions on behalf of the partnership. J will be held liable as a partner even though he objects promptly and tells K and L that he will not be bound by the action.
a. Dispose of the good will of the business.
b. Submit a partnership claim to arbitration.
c. Submit a bid on a contract which J feels is disastrously underpriced.
d. Distribute $\$ 5,000$ to each partner out of his capital investment.
e. None of the above.
14. J feels that he is entitled to more income than the other partners, since he has contributed more time and has invested more capital than the other partners. In the absence of any provisions in the partnership agreement J would be entitled to be compensated as follows:
a. Interest on loans made to the firm.
b. A share of profits in proportion to capital contributed.
c. A share of profits in proportion to time spent on partnership business.
d. A reasonable rate of salary for the extra time spent on partnership business, plus an equal share of remaining profits.
e. None of the above.
15. Creditors of the partners and the partnership have instituted suit against them resulting in a marshaling of assets. Claims of the partnership creditors will be settled as follows:
a. Against firm assets only, but if they are insufficient, then against the individual assets of the partners in excess of the amount necessary to satisfy, separately, the partners' individual creditors, but in proportion to the capital contributions of the respective partners.
b. Same as $a$ but in proportion to the profit sharing ratios of the respective partners.
c. Same as $a$ but without regard to the proportion borne by each respective partner.
d. Against firm assets or assets of individual partners in any manner or proportion to which the partnership's creditors may agree among themselves.
e. None of the above.

## Number 2 (Estimated time-20 to 30 minutes)

You are to select all of those phrases which state a correct legal conclusion based on general principles of law or provisions of the appropriate Uniform Act. Indicate your selection by placing an " X " in the appropriate column provided on the answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select correct answers will be penalized.

1. The following words in a written contract would effectively disclaim any implied warranty of fitness for use:
a. We assume no responsibility that the goods contained are fit for any particular purpose for which they are being bought outside of the general purposes of goods of the description.
b. The merchandise is sold "as is."
c. This contract contains all of the express warranties between the parties.
d. No warranties have been made unless written herein.
e. None of the above.
2. The following statements would be held to be express warranties of quality:
a. These shoes are first class merchandise.
b. This coat is $100 \%$ wool.
c. This horse is physically sound - (the buyer observes that the horse is obviously lame.)
d. Your boy can never wear out these roller skates.
e. None of the above.
3. The seller makes the following implied warranties of title:
a. In the case of a contract to sell, that the seller has a right to sell the goods at the time the contract is made.
b. The buyer shall have quiet possession as against claims arising after the time of the sale.
c. The goods are free at the time of sale from any charge or encumbrance in favor of any third person not declared or known to the buyer before or at the time the sale is made.
d. A sheriff at an execution sale warrants that the title is marketable.
e. None of the above.
4. A patron of a restaurant who was injured as a result of foreign matter in the food:
a. Could recover on the grounds of an implied warranty of fitness for human consumption.
b. Could recover on the ground of an implied warranty of merchantable quality.
c. Could not recover for breach of warranty, because the providing of food is a service, and not a sale.
d. Could recover, but only if negligence were proved.
e. None of the above.
5. The warranty of fitness for a particular purpose requires the following in order to be effective in favor of the buyer:
a. Seller must be a dealer in such goods.
b. Buyer must rely on the skill and judgment of the seller.
c. Buyer must expressly inform the seller of his reliance on the warranty.
d. Seller must not have made any express warranties.
e. None of the above.
6. The warranty of merchantable quality requires the following in order to be effective in favor of the buyer:
a. The breach of the warranty must have been due to a latent defect.
b. Buyer must rely on the skill and judgment of the seller.
c. Buyer must expressly inform the seller of his reliance on the warranty.
d. An order by a patent or other trade name will nullify the warranty.
e. None of the above.
7. In accordance with the trend of recent decisions, one who is injured as a result of eating packaged food which is contaminated can recover on a breach of the implied warranty of fitness for human consumption even though:
a. He seeks recovery from the retailer.
b. He seeks recovery from the manufacturer.
c. The one who consumed the food, and who is therefore suing, is not the the purchaser but is a member of the immediate family.
d. The one who consumed the food, and who is therefore suing, is not the purchaser, but is the guest of the purchaser.
e. None of the above.
8. The following circumstances would be considered a breach of the implied warranty of fithess for human consumption:
a. The use of veal in lieu of chicken in a chicken pie.
b. A pebble in a can of baked beans.
c. Iron filings in a bottle of root beer.
d. A pin in a loaf of bread.
e. None of the above.
9. The buyer can recover for breach of warranty of merchantable quality if he is given the right to examine the goods and a defect could be readily discovered:
a. If buyer does not discover an obvious defect upon his examination.
b. If the seller knows the examination is superficial.
c. If the buyer refuses to examine even though he is requested to do so.
d. If the warranty is an express warranty and buyer does not discover the defect.
e. None of the above.
10. When goods are purchased from a dealer under a patent or other trade name:
a. There are no implied warranties of quality.
b. There is an implied warranty of fitness for a particular purpose even though the dealer does not know or have reason to know of the purpose for which the goods are required.
c. There is an implied warranty of merchantable quality.
d. There are implied warranties of quality only if annexed by customs of the trade.
e. None of the above.
11. The following may be the subject matter of a present sale:
a. Goods to be manufactured.
b. Goods having potential existence.
c. An undivided share in an identified bulk of fungible goods.
d. Future goods.
e. Goods which are neither owned nor possessed by the seller.
12. The price requirement in a contract of sale will be satisfied if the terms call for:
a. Payment in personal property.
b. Determination of the price in accordance with a cost plus fixed fee agreement.
c. Determination of the price by a third party's valuation.
d. Determination of the price by custom of the trade.
e. Payment of a reasonable price.
13. The following persons can transfer good title to goods to an innocent purchaser for value:
a. One having voidable title.
b. A seller in possession of goods already sold.
c. A thief.
d. One to whom the goods have been consigned for sale.
e. One who has obtained the goods by fraud in the inducement.
14. The seller will have the right to stoppage in transit against an insolvent buyer unless:
a. Buyer has received a negotiable document of title to the goods.
b. Buyer has received an acknowledgement by the carrier that it is holding the goods as a warehouseman for the buyer.
c. Buyer has received the goods .
d. Buyer has negotiated a negotiable document of title to the goods to an innocent purchaser for value.
e. Buyer has already made a contract for the sale of the goods.
15. Where the buyer has notified the seller of a breach of warranty discovered shortly after receipt and acceptance of the goods, the buyer can:
a. Deduct the reasonable value of the breach from the sale price.
b. Revoke or rescind his acceptance even though he manifested the acceptance to the seller in writing.
c. Sue for damages, but only if he returns the goods.
d. Have no recourse against the seller because he accepted the goods.
e. None of the above.

## Number 3 (Estimated time- 20 to 30 minutes)

You are to select all of those phrases which state a correct legal conclusion based on general principles of law and provisions of the appropriate Uniform Law. Indicate your selection by placing an " X " in the appropriate column provided on the answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select correct answers will be penalized.

While counting the cash of your client, Thomas Taylor, in connection with your regular annual audit on September 30, 1960, you examine a note receivable with terms as presented below. (Solely for convenience of reference in this series of questions, the terms of the note are broken into short, lettered phrases.)
A. July $10,1960$.
B. Ninety (90) days from date.
C. I promise to pay.
D. To the order of.
E. James Martin.
F. The sum of $\$ 500.00$
G. Five Hundred and no/100 Dollars.
H. (Signature) Ray Johnson.

Except as modified by the particular facts given in each question, you are to assume that the terms of the note are identical in content, that the note is properly
endorsed in blank, and that it was received in the usual course of business on the date of your cash count without any actual notice of any infirmities other than those on the face of the instrument itself.

1. Taylor could be a holder in due course even if " $H$ " were:
a. Printed with special signature plate.
b. Typewritten.
c. Rubber stamped.
d. Written in pencil.
e. None of the above.
2. Taylor would be a holder in due course if "A" were:
a. June 10, 1960.
b. October 10, 1960.
c. Blank.
d. July 10.
e. None of the above.
3. Taylor would be a holder in due course if " B " were:
a. On demand.
b. Within a reasonable time from date.
c. Upon his graduation from college.
d. On or before October 10, 1960.
e. None of the above.
4. Ray Johnson would be liable on the instrument as maker if " H " consisted of the following: (assume that the agent has proper authority to sign)
a. Ray Johnson, by Dick Brown, agent.
b. Ray Johnson, agent for Dick Brown.
c. Ray Johnson, agent.
d. Ray Johnson, president.
e. None of the above.
5. Taylor would be a holder in due course if "C" were deleted and the following words substituted:
a. I promise to pay from the proceeds of the sale of my automobile.
b. I intend to pay.
c. I will pay.
d. I owe.
e. None of the above.
6. Taylor would be holder in due course if " F " were:
a. $\$ 500$ plus interest.
b. $\$ 500$ plus interest at $6 \%$ per annum.
c. $\$ 500$ plus reasonable attorney's fees and court costs.
d. $\$ 500$ plus exchange at current rate.
e. None of the above.
7. Taylor would be a holder in due course if the note were endorsed:
a. Pay to Robert Miller, James Martin.
b. James Martin, without recourse.
c. Harry Allen, James Martin.
d. James Martin (Taylor knows Martin is an infant).
e. None of the above.
8. Taylor would be a holder in due course if the note had terms indicating "I promise to pay to the order of James Martin or bearer . . ." (instead of items "C," " D " and " E ") and the note were endorsed as follows:
a. Pay to Taylor only, James Martin.
b. James Martin, without recourse.
c. Harry Allen, James Martin.
d. James Martin (Taylor knows Martin is an infant).
e. None of the above.
9. Taylor would be a holder in due course if item " $E$ " were "James Martin and Harry Allen" and the note were endorsed:
a. Pay to Robert Miller, James Martin.
b. James Martin, without recourse.
c. Harry Allen, James Martin.
d. James Martin (Taylor knows Martin is an infant).
e. None of the above.
10. Taylor would be a holder in due course if:
a. He purchased the note for $\$ 425$.
b. He made no attempt to determine how the customer who negotiated the note had obtained it. The customer, who was a respected citizen and known to Taylor, had stolen the note.
c. He exhausted all reasonable sources of information except applying to the maker himself and found nothing wrong.
d. He accepted the note as full payment for the pre-existing debt of $\$ 550$.
e. None of the above.
11. If Taylor received the note from a holder in due course, Taylor could recover from the maker even though:
a. The maker issued the note in payment for some fraudulent mining stock. Taylor did not know that the maker was a victim of fraud.
b. Same as $a$, but Taylor knew that the maker was a victim of fraud.
c. Taylor had previously acquired the note from the maker by fraud but paid full value to the holder in due course in reacquiring the instrument.
d. Taylor received the note by assignment from the holder in due course, knowing it had been issued without consideration.
e. None of the above.
12. Taylor acquired the note as security for a loan. If the maker has a valid personal defense against the person from whom Taylor acquired the note:
a. Taylor can recover the face amount of the note from the maker if he otherwise meets the requirements of a holder in due course.
b. Taylor can recover nothing from the maker even though he otherwise meets the requirements of a holder in due course.
c. Taylor can recover from the maker only the amount of his loss on the loan even though he is otherwise a holder in due course.
d. Taylor can recover from the maker the amount of his loss on the loan even though he knew of the maker's defense when he took the instrument.
e. None of the above.
13. Johnson would have a complete defense against Taylor under the following circumstances:
a. Johnson had made payment in full to another person before maturity.
b. Johnson had made payment in full to another person after maturity.
c. Martin lost the instrument and Taylor acquired it from the finder.
d. The instrument was stolen from Martin, and Taylor acquired it from the thief.
e. None of the above.
14. Johnson would have a complete defense against Taylor under the following circumstances:
a. Johnson's agent completed the instrument for a greater amount than that authorized.
b. Johnson's agent had no authority to sign the note.
c. Martin's endorsement was forged by a finder of the instrument.
d. The amount of the instrument had been raised after completion. (The alteration was not apparent on the face of the instrument.)
e. None of the above.
15. Johnson would have a complete defense against Taylor under the following circumstances:
a. Taylor is an infant.
b. Martin is an infant.
c. Johnson is an infant.
d. The person from whom Taylor acquired the note is an infant.
e. None of the above.

## Number 4 (Estimated time- 20 to 30 minutes)

You are to select all of those phrases which state a correct legal conclusion based on general principles of law. Indicate your selection by placing an "X" in the appropriate column provided on the answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select the correct answers will be penalized.

1. Composition Agreements are:
a. Generally used in an attempt to preserve a going concern and to avoid the cost and delay of a bankruptcy proceeding.
b. Supported by consideration if they are to be enforceable.
c. Not binding on non-assenting creditors according to the Federal Bankruptcy Act.
d. Arrangements whereby the creditors agree to accept a lesser amount which is distributed pro rata in discharge of their claims.
e. None of the above.
2. In an assignment for the benefit of creditors:
a. The trustee conserves and rehabilitates the going concern transferred to him.
b. The debtor must irrevocably transfer title and control over the assets assigned.
c. The assignee, in effect, acts as a trustee for the benefit of creditors.
d. Non-assenting creditors cannot reach assets which have been assigned for the benefit of creditors.
e. None of the above.
3. The Federal Bankruptcy Act:
a. Was based upon the English and American case law which had developed prior to its enactment.
b. Was passed by Congress pursuant to power granted by the Constitution.
c. Provides for both voluntary and involuntary bankruptcy petitions.
d. Provides a means whereby an honest but insolvent debtor may secure relief from his debts.
e. None of the above.
4. Insolvency in the bankruptcy sense:
a. Is the same as insolvency in the equity sense.
b. Is a financial status in which the aggregate value of assets, at a fair valuation, is not sufficient to pay outstanding liabilities.
c. Means the inability to meet debts as they mature.
d. Is determined on the basis of the most recent annual balance sheet prepared by the debtor's accountants.
e. None of the above.
5. An involuntary petition in bankruptcy:
a. Must state that the alleged bankrupt has committed one or more of the six acts of bankruptcy within four months of filing.
b. May be filed only if the alleged bankrupt owes $\$ 1,000$ or more.
c. May be filed by a single creditor if there are less than twelve creditors and the creditor's provable claim, fixed as to liability, and liquidated as to amount is at least $\$ 500$ in excess of any security he holds.
d. May be filed by three or more creditors if the number exceeds twelve and their provable claims, fixed as to liability, and liquidated as to amount aggregate at least $\$ 500$ in excess of any security held.
e. None of the above.
6. The following natural persons or business entities may be petitioned into bankruptcy:
a. An individual personally engaged in farming.
b. An insurance company.
c. A railroad.
d. A wage earner with an annual compensation of $\$ 1,200$.
e. None of the above.
7. Solvency as used in the bankruptcy sense is a complete defense by the debtor to the following acts of bankruptcy:
a. A fraudulent conveyance.
b. A written admission of inability to pay one's debts and the debtor's desire to be adjudicated a bankrupt.
c. An assignment for the benefit of creditors.
d. Making or suffering a preferential transfer.
e. Appointment of a receiver or trustee.
8. A trustee in a bankruptcy proceeding:
a. Serves in cases where a referee is not appointed by the court.
b. Is usually elected by the creditors.
c. Must examine all proofs and object to the allowance of improper claims.
d. Has title to property transferred by the bankrupt in fraud of creditors.
e. None of the above.
9. A preference in bankruptcy:
a. To be voidable, requires (among other things) that the creditor receiving the preference know or have reasonable cause to believe that the debtor was insolvent at the time of the transfer.
b. Prefers one creditor above the others.
c. Will not result from a transfer of property for a fair present consideration (assuming all other requirements are present).
d. Will result from the present transfer of property as security for a prior debt.
e. None of the above.
10. Debts of the bankrupt may be proved and allowed against his estate which are founded upon:
a. Contingent tort claims.
b. Claims arising under implied contracts.
c. Workmen's compensation awards.
d. Judgments obtained prior to the filing of the bankruptcy petition.
e. None of the above.
11. Under the Bankruptcy Act a priority:
a. Is a term that may be used interchangeably with "secured interest."
b. Will be paid in full before the general creditors receive a share.
c. Is given to administration costs which include attorneys' and accountants' fees.
d. Is given to wage claims without qualification as to amount.
e. None of the above.
12. Bankruptcy offenses:
a. May only be committed by the bankrupt.
b. Will result in denial of a discharge for the bankrupt.
c. Include concealing property or information concerning property of a bankrupt from an officer or creditor entitled to them.
d. Include concealing, mutilating or falsifying books of account in contemplation of a bankruptcy.
e. None of the above.
13. The following provable debts are discharged by bankruptcy:
a. Federal and state taxes.
b. Alimony payments.
c. Claims resulting from the breach of a fiduciary duty.
d. Claims resulting from the negligence of the bankrupt.
e. All wages earned by workmen prior to commencement of bankruptcy proceedings.
14. A section of the Bankruptcy Act provides for corporate reorganizations. The chapter provides:
a. For voluntary and involuntary petitions for reorganization.
b. For reorganizations of corporations that are eligible for or subject to a bankruptcy proceeding.
c. That a petition for reorganization may be filed only after an adjudication of bankruptcy.
d. That in all cases the property of the corporation is transferred to a trustee.
e. None of the above.
15. Under a wage-earners' plan:
a. A wage earner is defined as one who worked for wages, salary or hire at a rate of compensation that, when added to income from other sources, does not exceed $\$ 5,000$.
b. Is dependent upon the written consent of the majority in number and amount of all unsecured claims and the consent of all secured creditors whose claims will be materially affected by the plan.
c. Does not involve the matter of priorities and exemptions.
d. Is one of several types of debt relief recognized under the Federal Bankruptcy Act.
e. None of the above.

## Number 5 (Estimated time- 15 to 25 minutes)

The Acme Industrial Corporation was formed in 1959 and was incorporated in State X . The company prospered and as a result of this prosperity it expanded very rapidly. In fact, due to large sales of its products in the neighboring State Y, the company established a sales office there. Subsequently, a warehouse was purchased for storage of goods in State $\mathbf{Y}$ and a service and maintenance section added to the State Y operation. Acme never incorporated in State Y and never took any steps such as obtaining a license or qualifying to "do business" in State Y.

## Required:

a. Define the following terms as they are used in the law of corporations and relate these definitions to the facts above:

1. Domestic corporation.
2. Foreign corporation.
b. What criteria would be used to ascertain if Acme Industrial Corporation was "doing business" in State Y?
c. What are the sanctions or penalties that may be imposed on Acme, or those connected with it, for failure to comply with the licensing requirements?
d. What four factors must be present in order to have a de facto corporation?

## Number 6 (Estimated time-15 to 25 minutes)

Able desired to purchase Blackacre from Victor. After considerable bargaining Able and Victor finally came to terms, and an oral contract for the sale of Blackacre and the buildings thereon was agreed to by the parties. Payment and convey-
ance by bargain and sale deed was to be made in one month. Able, wanting to be protected in the event of destruction of the buildings located on Blackacre, immediately went to the Indemnity Insurance Company and took out their standard fire insurance policy on the buildings. Ten days after taking out the policy the buildings were totally destroyed by fire. The insurance company upon learning of the fact that the contract of sale was oral, denied they had any liability on the policy, and told Able he would not receive anything from them.

## Required:

a. What rights, if any, does Able have to collect from the Indemnity Insurance Company? Explain.
b. Explain any four of the following terms as used in insurance law and indicate the type of policy in which the term is typically used:

1. Binder
2. Open policy
3. Sound health clause
4. Hostile fire
5. Warranty

## GROUP II

(Estimated time- 30 to 40 minutes)
(Answer two of the three questions in this group. If all three
are answered, only the first two will be considered.)

## Number 7

Daniel, a building contractor, was negotiating with Lucas for a contract to construct an apartment house. Lucas, desirous of additional assurance of completion or desirous of adequate damages in the event of failure to complete, insists that Daniel obtain a mutually acceptable third party to perform in the event of default or to reimburse Lucas for any damages he may suffer from Daniel's failure to perform. Frank was obtained by Daniel as the third party, and he was acceptable to Lucas. The contract was drafted, and it stated that in the event of default by Daniel, Frank would have the privilege of completing the building or, in the alternative, of paying compensatory damages. The parties all signed the contract.

## Required:

a. Name and discuss the legal relationship among the parties.
b. If Daniel defaults and Frank pays $\$ 10,000$ damages (the fair value of the cost to complete) to Lucas, what recourse does Frank have against Daniel? Explain.
c. Instead of paying damages Frank elects to complete the contract and incurs reasonable costs of $\$ 8,000$ in this connection. Under the terms of the contract there is a $\$ 12,000$ final payment which Lucas pays to Frank. Does Frank have a right to retain any, all or part of the $\$ 12,000$ ? Explain.

## Number 8

Rollo owned certain land which he developed into a successful and valuable cranberry farm. The farm included an elaborate water and sprinkling system. Needing additional capital, Rollo borrowed $\$ 25,000$ from the Mortgage Savings and Loan Bank. He executed a note for the $\$ 25,000$ secured by a real estate mortgage on the farm. This mortgage was recorded the next day. After describing the land, the mortgage provided:

> "Together with all and singular tenements, hereditaments thereunto belonging or in anywise appertaining and any and all fixtures upon said premises at the time of execution or at any time during the term of this mortgage."

Subsequently Rollo borrowed $\$ 5,000$ from the Cranberry Credit Association, giving a note for $\$ 5,000$ secured by certain chattel mortgages covering the watering and sprinkling system. Rollo defaulted on the debt owed to Mortgage Savings and Loan and they foreclosed the real estate mortgage. The Cranberry Credit Association intervened and claimed a lien superior to that of the Mortgage Savings and Loan Bank insofar as the water and sprinkling system was concerned.

The property in dispute, i.e., the water and sprinkling system, included pipe lines consisting of trunk lines and lateral pipe lines, sprinkler heads, pumps, motors, frames, power poles, wiring and transformers. The above property constituted an integrated system installed with the intent of making a permanent improvement, actually annexed to the realty, and designed and constructed to make the particular land a commercial cranberry farm.

## Required:

a. Define the term fixture as used in real property.
b. List and explain the rules or tests followed in deciding whether personal property attached to land has become real property.
c. In the above situation does the Cranberry Credit Association or the Mortgage Savings and Loan Bank have the superior right to the property in dispute? Explain.

## Number 9

a. Terrance owns and operates a gas station and restaurant on a highway about a mile from a beautiful, but undeveloped, lake region. Regis, seeing the value of the lake region as a potential resort area, purchases several acres of lake front property. He then enters into a contract with Mike, a building contractor, to have him construct an elaborate hotel and ten beautiful cottages.

Terrance, learning of these facts from a conversation with Regis, expands his restaurant and gas station facilities in contemplation of a substantial increase in business. Subsequently, Regis decides not to go ahead with his plans, but instead to breach the contract with Mike. He promptly notifies Mike not to commence construction and Mike complies with the instructions. Terrance, learning of the change in plans, sues Regis for breach of contract. He claims that he (Terrance) is a third party beneficiary under the contract between Regis and Mike and therefore entitled to damages for the costs incurred in expanding his business and the profits he would have reaped had the contract been performed.
(1) Can Terrance recover? Explain.
(2) List and define the three kinds of third party beneficiaries.
b. Define and distinguish between a contract which is implied in fact and a quasi contract.

# EXAMINATION IN THEORY OF ACCOUNTS 

November 4, 1960; 1:30 to 5:00 p.m.

## GROUP 1

## (Answer all questions in this group.)

## Number 1 (Estimated time- 15 to 25 minutes)

Consider each of the items below. You are to indicate the nature of the account or accounts to be debited when recording each transaction using the preferred accounting treatment by placing an " X " in the proper column on the answer sheet provided. Prepayments should be recorded in balance sheet accounts. Disregard income tax considerations unless instructed otherwise.

## Column

A - Asset(s) only
B - Accumulated amortization, depletion or depreciation only
C - Expense only
D - Asset(s) and expense
E - Some other account or combination of accounts

1. The Talbot Co. spent $\$ 8,600$ during the year for experimental purposes in connection with the development of its product. This is approximately the same amount that the company has been spending for this purpose annually for many years.
2. In April, the West Co. paid cash of $\$ 2,800$ because a suit was lost in defense of a patent infringement case.
3. The Miller Co., plaintiff, paid $\$ 5,000$ in legal fees in December, in connection with a successful infringement suit on its patent. No damages were awarded.
4. The Placey Company recently purchased land and two buildings for a total cost of $\$ 35,000$, and entered the purchase on the books. Razing costs of $\$ 1,200$ were incurred in removing the smaller building, which had an appraised value at acquisition of $\$ 6,200$, in order to make room for new construction.
5. In March, the Bijou Theatre bought projection equipment on the installment basis. The contract price was $\$ 23,610$, payable $\$ 5,610$ down, and $\$ 2,250$ a month for the next eight months. The cash price for this equipment was $\$ 22,530$.
6. On June 1, the Geneva Hotel installed a sprinkler system throughout the building at a cost of $\$ 13,000$. As a result the insurance rate was decreased by $40 \%$.
7. The Dibble Company traded its old machine with a net book value of $\$ 3,000$ plus cash of $\$ 7,000$ for a new one which had a fair market value of $\$ 9,000$.
8. A motor in one of Company B's trucks was overhauled at a cost of $\$ 600$. It is expected that this will extend the life of the truck for two years.
9. The cost of re-arranging machinery which had originally cost $\$ 130,000$, including installation, in order to improve production was $\$ 450$.
10. An improvement, which extended the life but not the usefulness of the asset, cost \$6,000.
11. Joe Donald and Frank Rice, maintenance repair men, spent five days in unloading and setting up a new $\$ 6,000$ precision machine in the plant. The wages earned in this five-day period totaled $\$ 240$.
12. The Edison Electric Company recorded the first year's interest on $6 \%$, $\$ 100,000$ ten-year bonds sold a year ago at 94 . The bonds were sold in order to finance the construction of a hydro-electric plant. Six months after the sale of the bonds the construction of the hydro-electric plant was completed and operations were begun.
13. The attic of the Business Building was finished at a cost of $\$ 3,000$ to provide an additional office.
14. The ABC Company, the owner of a building, purchased an old lease from tenants for $\$ 500$ in order to occupy the building before expiration of the original lease four years hence.
15. The Hiway Supermarket Co. erected a building at a cost of $\$ 25,000$ on land owned by the Madison Syndicate. The Hiway Supermarket has a 25 year lease. All building costs and six lease payments to the Madison Syndicate after the building was completed have been charged to Suspense. You are correcting these entries as of June 30, the end of Hiway's fiscal year.
16. In July, the Hiway Supermarket Co., (the same company as in item 15) in accordance with the terms of its lease, paid the real estate tax based on the assessed value of the building and land. The estimated tax had been accrued as of June 30 at $\$ 250$ less than the actual tax.
17. In July, the Hiway Supermarket Co. (same company as in item 15) paid a special assessment. The special assessment provided funds for the construction of public streets in the area in which the market was located.
18. In April, Fraser Investment Co. paid $\$ 1,700$ to the Rio Grande Drilling Co. as part payment of its share of lease, drilling and development costs in a successful oil drilling venture.
19. In September, Schaner \& Vandegrift Co. purchased Fraser's interest in certain producing wells and undeveloped leases for $\$ 25,000$.
20. In December, Schaner \& Vandegrift Co. paid $\$ 372$ for operating expenses and $\$ 1,200$ for completion costs of a new well. It is estimated that pipe used will have salvage value of $\$ 300$.

## Number 2 (Estimated time- 20 to 30 minutes)

A proper determination of income requires a matching of expenses and revenues. The assignment of revenues to periods, however, is determined by the choice of the appropriate realization or recognition principles. While the point of sale or the time of providing a service is often considered the appropriate time of recognition, accountants have accepted other realization points. These others include the point of partial or full completion of production and the point of partial or full conversion into cash. Once the realization principle has been chosen, the matching principle requires an approriate valuation of inventories and other assets and liabilities. For example, the valuation of accounts receivable at net selling price (the valuation of the asset received in exchange for the merchandise sold) implies that revenue has been realized at the point of sale or earlier.

## Required:

For each of the following valuation bases or methods:
a. State the point at which revenue was realized.
b. Give an example or illustration of the correct usage of each.
c. State the accounting principle or reason involved in determining the realization point or valuation basis.

1. Inventory recorded at cost.
2. Accounts receivable recorded at selling price with an account called "Deferred gross profit" having a credit balance.
3. Inventory recorded at selling price less a normal mark-up.
4. Inventory recorded at the net figure of selling price less costs to complete.
5. Inventory recorded at realization value (selling price).

## Number 3 (Estimated time- 15 to 20 minutes)

The Statement of Affairs and the Statement of Realization and Liquidation are two kinds of specialized reports prepared to indicate the financial position of a business entity under certain conditions.

## Required:

Contrast the form, use, and underlying assumptions of the usual Balance Sheet, the Statement of Affairs and the Statement of Realization and Liquidation. (You need not illustrate the different statements.)

## Number 4 (Estimated time- $\mathbf{1 5}$ to 20 minutes)

Identify four methods or bases used in applying or allocating overhead expenses. What are the advantages and disadvantages of each method?

## Number 5 (Estimated time- 25 to 35 minutes)

a. What is the common objective of depreciation based on replacement cost and the last-in, first-out method of pricing inventories?
b. Outline two conditions necessary for the last-in, first-out method of pricing inventories to accomplish the results expected of this method.
c. A basic monetary concept underlying accounting and financial statements is primarily responsible for the development of these methods of accounting. Name and briefly discuss this monetary concept as it is related to these methods of accounting.
d. List four arguments in opposition to modifying financial statements for price level changes.

## Number 6 (Estimated time- 20 to 30 minutes)

a. The terms purchase and pooling of interests describe two methods designating the result of bringing together two or more corporations into a combination for the purpose of carrying on the previously conducted businesses. Define the
terms purchase and pooling of interests as used to designate business combinations.
b. Describe the accounting treatment in each case.
c. Prepare Wesco's journal entries from the following data to record the combination of Wesco, Southco and Eastco.

Effective December 31, 1959, Wesco Corporation proposes to acquire, in exchange for common stock, all of the assets and liabilities of Southco Corporation and Eastco Corporation, after which the latter two corporations will distribute the Wesco stock to their shareholders in complete liquidation and dissolution. Wesco proposes to increase its outstanding stock for purposes of these acquisitions. Balance sheets of each of the corporations immediately prior to merger on December 31, 1959, are given below. The assets are deemed to be worth their book values.

|  | Wesco | Southco | Eastco |
| :---: | :---: | :---: | :---: |
| Current assets | \$ 2,000,000 | \$ 500,000 | \$ 25,000 |
| Fixed assets (net) | 10,000,000 | 4,000,000 | 200,000 |
| Total | \$12,000,000 | \$4,500,000 | \$225,000 |
| Current liabilities | \$ 1,000,000 | \$ 300,000 | \$ 20,000 |
| Long term debt | 3,000,000 | 1,000,000 | 105,000 |
| Capital stock (\$10 par) | 3,000,000 | 1,000,000 | 50,000 |
| Retained earnings | 5,000,000 | 2,200,000 | 50,000 |
| Total | \$12,000,000 | \$4,500,000 | \$225,000 |
| Other data relative to acquisition- |  |  |  |
| Shares outstanding | 300,000 | 100,000 | 5,000 |
| Fair market value per share | \$40 | \$40 | \$30 |
| No. shares Wesco stock to be |  | 100,000 |  |
| for Eastco assets |  |  | 5,000 |
| Old management to continue? |  | Yes | No |
| Old shareholders to elect director Wesco Board? |  | Yes | No |

## GROUP II <br> (Estimated time- 30 to 50 minutes.)

(Answer only two questions in this group. If three are answered only the first two will be considered.)

## Number 7

a. Explain what stock rights are and the accounting for them by recipients. (Disregard income tax considerations.)
b. John Manus holds 100 shares of Harper Company stock, which he purchased in 1958 for $\$ 90$ a share. On September 10, 1960 Harper Company declares stock rights will be made available to stockholders of record September 20, the
rights to expire on October 10. The rights permit the purchase of one share of stock at $\$ 100$ for every four shares held. The stock is sold on September 15 rights-on at $\$ 120$. The stock has a par value of $\$ 25$ per share. What should be the theoretical value of each right when these are sold separately on September $16 ?$

## Number 8

a. Describe in order of preference alternative methods of accounting for the receipt and immediate disposition of donated treasury stock which was originally issued at its fair market value and had no aspect of a "treasury stock subterfuge."
b. In connection with your first audit of a mining company, you note the following facts concerning its capital stock transactions:

1. Authorized capital consists of $5,000,000$ shares of $\$ 1$ par value common stock.
2. All $5,000,000$ shares were issued initially in exchange for certain mineral properties, which were recorded at an amount equal to twice the par value of the shares issued.
3. Soon thereafter, due to the need of additional working capital, $3,000,000$ of the shares were donated to the company and immediately were sold for $\$ 4,500,000$ cash, resulting in a credit to paid-in capital of this amount.
(a) What values should be assigned to the mineral properties and the stockholders' equity? Discuss.
(b) What adjustment, if any, would you recommend?

## Number 9

With regard to the problem of "accounting for pension cost," explain the significance of each of the following items on corporate financial statements. Show how each is consistent with generally accepted accounting principles.
(Note: All items set forth below are not necessarily to be found on the statements of a single company.)
a. Under the caption Deferred Charges:

Deferred Pension Cost, (attributable to Funding of Past Service Liability)
b. Under the caption Retained Earnings Appropriated:

Reserve for Past Service Pension Cost (after deducting the related anticipated tax reduction)
c. On the Income Statement:

Current Service Cost
Past Service Cost
Trustee's Fees

## EXAMINATION IN ACCOUNTING PRACTICE-PART I

## May 17, 1961; 1:30 to 6:00 p.m. <br> (All problems are required.)

## Number 1 (Estimated time- 25 to 35 minutes)

Part A
Given below are terms appearing in the federal income tax code, regulations and explanations.
A. Adjusted gross income
B. Capital contribution
C. Capital gain or loss
D. Consent dividend
E. Constructive dividend
F. Constructive receipt
G. Controlled corporation
H. Corporate dividend
I. Cost depletion
J. Deferred income
K. Dividend received credit
L. Dividend received deduction
M. Dividend received exclusion
N. Fair market value
O. Gift
P. Gross income
Q. Liquidating dividend
R. Nontaxable exchange
S. Patronage dividend
T. Percentage depletion
U. Personal holding company
V. Regulated investment company
W. Substituted basis
X. Taxable income
Y. Wash sale
Z. None of the above

Place the appropriate letter in the column on an answer sheet indicating your choice of the best term applying to the statements below. The terms may be used more than once.

1. A corporation whose income was derived solely from dividends, rents and mineral royalties, and during the last six months of its year $50 \%$ or more of the value of the outstanding stock is owned by five or fewer stockholders.
2. The basis used to determine gain on sale of a gift.
3. Sale of property to a corporation by shareholder for an amount in excess of its value.
4. An amount which is computed from an individual's dividends received from domestic corporations and is computed at a rate of $4 \%$ subject to certain limitations. The amount so computed for the individual is applied against the tax.
5. Income subject to tax less certain deductions which are permitted by law if incurred in trade or business.
6. Income from all sources minus all allowable income tax deductions and exemptions.
7. Distributions by a corporation after stockholders had agreed to reduce the size of the company.
8. At the request of a retiring officer-stockholder, a substantial advance was cancelled by the corporation.
9. The subtraction from a corporation's taxable income of $85 \%$ of dividends received from taxable domestic corporations with certain limitations.
10. Money received in error from a debtor by a taxpayer in excess of an agreed amount.
11. The cancellation by a stockholder of a debt owed him by the taxpayer corporation.
12. An allowance permitted in case of mine and mineral deposits directly related to the gross income from the property. This allowance is limited to $50 \%$ of the taxable income from the property, computed without the allowance.
13. Distribution by a cooperative to avoid payment of income tax by maintaining tax-exempt status.
14. The trade-in of obsolete production machinery for new production machinery by a corporation. "Boot" is paid by the corporation.

## Part B

Smith, who is 57 years of age, owns $70 \%$ of the stock of Smith's Food Stores. He proposes to sell all of his stock to his son in consideration for an annuity contract whereby the son agrees to pay his father a certain sum each year for the remainder of his father's lifetime.

The following details include all information necessary to complete the required computations.

$$
\begin{aligned}
& \text { Estimated fair market value of } \\
& \quad \text { Mr. Smith's } 70 \% \text { stock interest . . . . . . . . . . . . . . } \\
& \text { Mr. Smith's tax basis in the stock } \\
& \text { of Smith's Food Stores . . . . . . . . . . . . . . . . . . . . }
\end{aligned} \begin{array}{|}
\$ 246,000 \\
\text { Annual payment . . . . . . . . . . . . . . . . . . . . . . . . } & \$ 40,000 \\
\text { Mr. Smith's life expectancy } \\
\quad \text { (to nearest whole year) . . . . . . . . . . . . . . . . . . . . . } & 20 \text { years }
\end{array}
$$

On the answer sheet provided, print next to the number of each statement the capital letter of the answer that correctly completes the statement.
15. The percentage of the annual payment which can be excluded from ordinary income is:
a. $30.8 \%$
b. $40 \%$
c. $77 \%$
d. None of these
16. The proportion of the annual payment which is treated as ordinary income will:
a. Remain constant throughout the expected life of the annuity.
b. Increase throughout the expected life of the annuity.
c. Decrease throughout the expected life of the annuity.
d. None of these.

## Part C

Wall owned unimproved real estate which cost him $\$ 7,500$ in 1950. The property was condemned on July 1, 1958 by the State as additional right-of-way. On August 1, 1959 Wall received $\$ 30,000$ as a condemnation award.

Wall, who files his return on a calendar year basis, elected to use involuntary conversion and replacement provisions of the Internal Revenue Code. No extension of the period for replacement was obtained. He has no other transactions involving investment or depreciable property.

Given below are various situations. Each situation is to be considered as a separate and distinct set of facts. On the answer sheet provided, print next to the number of each statement the capital letter of the answer that correctly completes the statement.

Assume Wall purchased unimproved real estate from the proceeds at a cost of $\$ 25,000$ on December 1, 1960.
17. The gain or loss recognized for federal income tax purposes is:
a. $\$ 5,000$
b. $\$ 17,500$
c. $\$ 22,500$
d. None of these.
18. The gain or loss would be a:
a. Short-term capital gain or loss.
b. Long-term capital gain or loss.
c. Ordinary gain or loss.
d. None of these.
19. The basis of the property purchased is:
a. \$7,500
b. $\$ 12,500$
c. $\$ 25,000$
d. None of these.

Assume Wall purchased unimproved real estate from the proceeds at a cost of $\$ 25,000$ on January $15,1961$.
20. The gain or loss recognized for federal income tax purposes is:
a. $\$ 5,000$
b. $\$ 17,500$
c. $\$ 22,500$
d. None of these.
21. The basis of the property purchased is:
a. \$ 7,500
b. $\$ 12,500$
c. $\$ 25,000$
d. None of these.
22. Any gain or loss recognized should be reported in the return for the taxable year:
a. 1959
b. 1960
c. 1961
d. Of final disposition.

Assume Wall purchased unimproved real estate from the proceeds at a cost of \$40,000 on November 15, 1960.
23. The gain or loss recognized for federal income tax purposes is:
a. $\$ 5,000$
b. $\$ 10,000$
c. $\$ 22,500$
d. None of these.
24. The basis of the property purchased is:
a. \$ 7,500
b. $\$ 17,500$
c. $\$ 40,000$
d. None of these.

Assume Wall purchased investment property, consisting of land and a building from the proceeds for $\$ 30,000$ on October 1, 1960.
25. The gain or loss recognized for federal income tax purposes is:
a. Zero (no recognition of gain or loss)
b. \$ 7,500
c. $\$ 22,500$
d. None of these.

## Part D

The following questions relate to federal income tax in connection with partnerships. Place an " X " in the appropriate column on the answer sheet indicating whether or not the statement is correct.
26. For federal income tax purposes the term "partnership" may include any of the following: a syndicate, group, pool, joint venture, or other unincorporated organizations which are not a trust or estate.
27. A partnership can take the net operating loss deduction in computing taxable income.
28. Partnership capital gains and losses are reported on the partnership return.
29. A partner's distributive share of items of depreciation, in absence of any agreement, will be allocated to the partners in proportion to cost of the depreciable property contributed by each partner.
30. A partnership on a June 30 fiscal year pays partner A a monthly salary. Partner A reporting on a calendar year basis will report the salary received July through December 1959 on his return filed for 1959.
31. A partnership taxable year is closed by the death of a partner even though the partnership is not terminated, as a general rule.
32. The basis of contributed property in the hands of the partnership is the same as the adjusted basis of the property to the contributing partner.
33. A son gave interests to his parents in a family partnership formed to reduce taxes. If capital is a material income producing factor, the partnership is valid.

## Number 2 (Estimated time- 50 to 80 minutes)

In connection with an audit of cash of Distributors, Inc., as at December 31, 1960 the following information has been obtained:

1. Balance per bank
11/30/60
\$ 185,700
12/31/60
193,674
2. Balance per books

11/30/60
154,826
12/31/60
167,598
3. Receipts for the month of December 1960

Per bank
1,350,450
Per books
2,335,445
4. Outstanding checks

11/30/60 63,524
12/31/60 75,046
5. Dishonored checks are recorded as a reduction of cash receipts. Dishonored checks which are later redeposited are then recorded as a regular cash receipt. Dishonored checks returned by the bank and recorded by Distributors, Inc. amounted to $\$ 6,250$ during the month of December 1960; according to the books $\$ 5,000$ were redeposited. Dishonored checks recorded on the bank statement but not on the books until the following months amounted to $\$ 250$ at November 30, 1960 and $\$ 2,300$ at December 31, 1960.
6. On December 31, 1960 a $\$ 2,323$ check of the ABC Company was charged to the Distributors, Inc. account by the bank in error.
7. Proceeds of a note of the Able Company collected by the bank on December 10, 1960 were not entered on the books:

| Principal | \$2,000 |
| :---: | :---: |
| Interest . | 20 |
|  | 2,020 |
| Less collection charge | 5 |
|  | \$2,015 |

8. The company has hypothecated its accounts receivable with the bank under an agreement whereby the bank lends the company $80 \%$ on the hypothecated accounts receivable. Accounting for and collection of the accounts are performed by the company, and adjustments of the loan are made from daily sales reports and daily deposits.
The bank credits the Distributors, Inc. account and increases the amount of the loan for $80 \%$ of the reported sales. The loan agreement states specifically that the sales report must be accepted by the bank before Distributors, Inc. is credited. Sales reports are forwarded by Distributors, Inc. to the bank on the first day following the date of sales.
The bank allocates each deposit $80 \%$ to the payment of the loan and $20 \%$ to Distributors, Inc. account.
Thus, only $80 \%$ of each day's sales and $20 \%$ of each collection deposit are entered on the bank statement.
Distributors, Inc. accountant records the hypothecation of new accounts receivable ( $80 \%$ of sales) as a debit to cash and a credit to the bank loan as of the date of sales. One hundred per cent of the collections on accounts receivable is recorded as a cash receipt; $80 \%$ of the collections is recorded in the cash disbursements book as a payment on the loan.
In connection with the hypothecation the following facts were determined:
a. Included in the deposits in transit is cash from the hypothecation of accounts receivable. Sales were $\$ 40,500$ on November 30, 1960 and $\$ 42,250$ on December 31, 1960. The balance of the deposit in transit at December 31, 1960 was made up from collections of $\$ 32,110$ which were entered on the books in the manner indicated above.
b. Collections on accounts receivable deposited in December other than deposits in transit totaled \$1,200,000.
c. Sales for December totaled $\$ 1,450,000$.
9. Interest on the bank loan for the month of December charged by the bank but not recorded on the books amounted to $\$ 6,140$.

## Required:

a. Prepare bank reconciliations as of November 30, 1960 and December 31, 1960 and reconciliations of cash receipts and disbursements per bank with cash receipts and disbursements per books for the month of December 1960. (Assume that you have satisfied yourself as to the propriety of the above information.) Show computations where applicable.
b. Prepare adjusting journal entries as required to correct the cash account at December 31, 1960.

## Number 3 (Estimated time- 25 to 40 minutes)

The Installment Jewelry Company has been in business for five years but has never had an audit made of its financial statements. Engaged to make an audit for 1960, you find that the company's balance sheet carries no allowance for bad accounts, bad accounts having been expensed as written off and recoveries credited to income as collected. The company's policy is to write off at December 31 of each year those accounts on which no collections have been received for three months. The installment contracts generally are for two years.

Upon your recommendation the company agrees to revise its accounts for 1960 to give effect to bad account treatment on the reserve basis. The reserve is to be based on a percentage of sales which is derived from the experience of prior years.

Statistics for the past five years are as follows:


Accounts receivable at December 31, 1960 were as follows:

| 1959 sales | \$ 15,000 |
| :---: | :---: |
| 1960 sales | 135,000 |
|  | \$150,000 |

## Required:

Prepare the adjusting journal entry or entries with appropriate explanations to set up the Allowance for Bad Accounts. (Support each item with organized computations; income tax implications should be ignored.)

Number 4 (Estimated time-35 to 55 minutes)
The net changes in the balance sheet accounts of X Company for the year 1960 are shown below:

|  | Debit | Credit |
| :---: | :---: | :---: |
| Investments |  | \$25,000 |
| Land | \$ 3,200 |  |
| Buildings | 35,000 |  |
| Machinery | 6,000 |  |
| Office equipment |  | 1,500 |
| Allowance for depreciation: |  |  |
| Buildings |  | 2,000 |
| Machinery |  | 900 |
| Office equipment | 600 |  |
| Discount on bonds | 2,000 |  |
| Bonds payable |  | 40,000 |
| Capital stock - preferred | 10,000 |  |
| Capital stock - common |  | 12,400 |
| Premium on common stock |  | 5,600 |
| Retained earnings |  | 6,800 |
| Working capital | 37,400 |  |
|  | \$94,200 | \$94,200 |

Additional information:

1. Cash dividends of $\$ 18,000$ were declared December 15,1960 , payable January 15, 1961. A $2 \%$ stock dividend was issued March 31, 1960, when the market value was $\$ 12.50$ per share.
2. The investments were sold for $\$ 27,500$.
3. A building which cost $\$ 45,000$ and had a depreciated basis of $\$ 40,500$ was sold for $\$ 50,000$.
4. The following entry was made to record an exchange of an old machine for a new one:

Machinery . . . . . . . . . . . . . . . . . . . . . . . . . . . . . \$13,000
Allowance for depreciation - Machinery . . . . 5,000
Machinery
\$7,000
Cash
11,000
5. A fully depreciated office machine which cost $\$ 1,500$ was written off.
6. Preferred stock of $\$ 10,000$ par value was redeemed for $\$ 10,200$.
7. The company sold 1,000 shares of its common stock (par value $\$ 10$ ) on June 15,1960 for $\$ 15$ a share. There were 13,240 shares outstanding on December 31, 1960.

Required:
A worksheet and statement of source and application of funds for the year 1960.

## Number 5 (Estimated time- $\mathbf{4 0}$ to 60 minutes)

The XYZ Corporation is a small manufacturing company producing a highlyflammable cleaning fluid. On May 31, 1960 the company had a fire which completely destroyed the processing building and the in-process inventory; some of the equipment was saved.

The cost of the fixed assets destroyed and their related allowances for depreciation at May 31, 1960 were:

| , | Cost | Allowance |
| :---: | :---: | :---: |
| Building | \$40,000 | \$24,667 |
| Machinery and equipment | 15,000 | 4,375 |

At present prices the cost to replace the destroyed property would be: building, $\$ 80,000$; machinery and equipment, $\$ 37,500$. At the time of the fire it was determined that the destroyed building was $62.5 \%$ depreciated, and the destroyed machinery and equipment was $33.3 \%$ depreciated. The insurable value of all the building and machinery and equipment was determined to be $\$ 75,000$.

After the fire a physical inventory was taken. The raw materials were valued at $\$ 30,000$, the finished goods at $\$ 60,000$, and supplies at $\$ 5,000$.

The inventories on January 1, 1960 consisted of:

| Raw materials | \$ 15,000 |
| :---: | :---: |
| Work-in-process | 50,000 |
| Finished goods | 70,000 |
| Supplies | 2,000 |
| Total | \$137,000 |

A review of the accounts showed that the sales and gross profit for the last five years were:

|  | Sales |  |
| :---: | ---: | ---: |
| 1955 | $\$ 300,000$ |  |
| 1956 | 320,000 |  |
| 1957 | 330,000 | 102,400 |
| 1958 | 250,000 | 108,900 |
| 1959 | 280,000 | 62,500 |
|  |  | 84,000 |

The sales for the first five months of 1960 were $\$ 150,000$. Raw material purchases were $\$ 50,000$. Freight on purchases was $\$ 5,000$. Direct labor for the five months was $\$ 40,000$; for the past five years manufacturing overhead was $50 \%$ of direct labor.

Insurance on the property and inventory was carried with three companies. Each policy included an $80 \%$ coinsurance clause. The amount of insurance carried with the various companies was:

|  | Building, Machinery and Equipment | Inventories |
| :---: | :---: | :---: |
| Company A | \$30,000 | \$38,000 |
| Company B | 20,000 | 35,000 |
| Company C | 15,000 | 35,000 |

The cost of cleaning up the debris was $\$ 7,000$. The value of the scrap salvaged from the fire was $\$ 600$.

## Required:

a. Compute the value of inventory lost.
b. Compute the expected recovery from each insurance company.

# EXAMINATION IN ACCOUNTING PRACTICE—PART II 

## May 18, 1961; 1:30 to 6:00 p.m.

## GROUP 1

(Solve all problems in this group.)

## Number 1 (Estimated time- 25 to 35 minutes)

White Corporation on the calendar year basis purchased business property on June 30, 1956 for $\$ 100,000$ cash. The appraised value of the land was $\$ 10,000$ and the remaining life of the building was estimated to be 50 years. Depreciation has been accumulated by use of the straight-line method.

On June 30, 1960 the property was sold for $\$ 150,000$ for which payment was received as follows:

1. $\$ 25,000$ cash on date of sale.
2. Four noninterest-bearing notes due as follows:

$$
\begin{aligned}
& \$ 30,000-6 / 30 / 61 \\
& \$ 30,000=6 / 30 / 62 \\
& \$ 50,000-6 / 30 / 63 \\
& \$ 15,000=6 / 30 / 64
\end{aligned}
$$

White Corporation elected to record the gain on the sale of the property on the installment method, inasmuch as the collection of the receivable is not reasonably assured.

## Required:

a. Prepare the necessary journal entries and computations to record the sale on June 30, 1960.
b. Furnish the necessary journal entries and computations to record the collection of the notes at their maturities.
c. State the sections of the balance sheet in which the account balances at December 31, 1960 should be shown.

## Number 2 (Estimated time-30 to 40 minutes)

The A Manufacturing Company presents you with the following information for the year ended December 31, 1960. The firm is primarily engaged in the manufacture of electronics equipment.

$$
\begin{aligned}
& \text { Sales . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . \$2,000,000 } \\
& \text { Cost of sales . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . } 1,100,000^{*} \\
& \text { Operating expenses . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 400,000 } \\
& \text { Loss of machinery due to earthquake, not insured . . . . . . . . . . } 50,000 \\
& \text { Gain on sale of warehouse acquired in } 1952 \text {................ . . } 100,000 \\
& \text { Retained earnings, January 1, } 1960 \text {. . . . . . . . . . . . . . . . . . . . . . . 800,000 } \\
& \text { Dividends paid during } 1960 \text {. . . . . . . . . . . . . . . . . . . . . . . . . . . . 80,000 } \\
& \text { Federal income tax accrual for } 1960 \text {................ (to be computed) } \\
& \text { *Includes depreciation of } \$ 15,000 \text { for a defense facility based upon a } 20 \text {-year } \\
& \text { life. However, this facility, which was constructed in } 1958 \text { at a cost of } \\
& \$ 300,000 \text {, is being written off over a } 60 \text {-month period for federal income } \\
& \text { tax purposes. }
\end{aligned}
$$

## Required:

Prepare a statement of income and retained earnings for the year ended December 31, 1960. For the purposes of this problem, assume that the nonrecurring items are material in nature. Consideration should be given to income tax implications. Use current corporation income tax rates.

## Number 3 (Estimated time- 40 to 55 minutes)

ABC Corporation acquired all of the outstanding stock of XYZ Corporation as of June 30, 1960. As consideration for the acquisition, ABC Corporation gave the stockholders of XYZ Corporation $\$ 550,000$ and 500,000 shares of previously unissued common stock in exchange for all the outstanding stock of the XYZ Corporation. The ABC Corporation stock had a par value of $\$ 1.00$ and a quoted market value of $\$ 2.50$ both before and after this transaction.

The balance sheet of XYZ Corporation as of June 30, 1960 was as follows:

|  |  | SSETS |  |  |
| :---: | :---: | :---: | :---: | :---: |
| CURRENT ASSETS |  |  |  |  |
| Cash |  |  | \$120,000 |  |
| Accounts receivable |  |  | 240,000 | \$ 570,000 |
| Inventories |  |  | 210,000 |  |
| FIXED ASSETS | Cost | Allowance for Depreciation | Net |  |
|  |  |  |  |  |
| Property A | \$ 310,000 | \$160,000 | \$150,000 |  |
| Property B | 370,000 | 170,000 | 200,000 |  |
| Property C | 480,000 | 180,000 | 300,000 |  |
| Property D | 250,000 | 150,000 | 100,000 | 750,000 |
|  | \$1,410,000 | \$660,000 | \$750,000 |  |
|  |  |  |  | \$1,320,000 |

## LIABILITIES

| Accounts payable |  | \$ 470,000 |
| :---: | :---: | :---: |
| Stockholders' equity |  |  |
| Common stock-authorized and outstanding |  |  |
| Paid-in capital in excess of par value | 100,000 |  |
| Retained earnings | 250,000 | 850,000 |
|  |  | \$1,320,000 |

All receivables are considered collectible. Inventories are stated at cost which is also equivalent to replacement cost and is not in excess of market. Properties B, C and D have been appraised at $\$ 600,000, \$ 800,000$ and $\$ 200,000$ respectively. Goodwill is not considered to be a significant factor in this business.

An engineer of the ABC Corporation estimates that the properties of the XYZ Corporation will have a ten-year useful life from July 1, 1960, with no salvage value at the end of that period. ABC Corporation uses the straight-line method of depreciating its assets.

On July 1, 1960 XYZ Corporation sold property A for $\$ 500,000$ and for the six months ended December 31, 1960 reported a net income of $\$ 450,000$ which included the gain from the sale of property A and depreciation of $\$ 55,000$. The balance sheet of XYZ Corporation at December 31, 1960 was:


On January 1, 1961 XYZ Corporation was dissolved and all of its assets were transferred to and its liabilities assumed by ABC Corporation. The transaction is to be accounted for as a purchase and not as a pooling of interests.

## Required:

a. Prepare the journal entry of ABC Corporation to record its investment in XYZ Corporation as of June 30, 1960, and explain the basis for the value assigned to the investment.
b. Prepare the journal entries to record the accounts of XYZ Corporation on the books of ABC Corporation upon dissolution of XYZ and explain how the amounts were determined. (Disregard income tax implications.)

## Number 4 (Estimated time-55 to 80 minutes)

The Southern Star Motel has been owned by Catron and Johnson on a $50 \%$ partnership basis. On April 1, 1961 Catron bought Johnson's interest and dissolved the partnership.

You have been engaged to act as a consultant to the accountant of the Southern Star Motel. The following trial balance was taken from the books of the motel as of March 31, 1961. The books were last closed December 31, 1960.

|  | Debit | Credit |
| :---: | :---: | :---: |
| Cash | \$ 630 |  |
| Petty cash | 100 |  |
| Prepaid insurance | 1,360 |  |
| Land | 32,500 |  |
| Building | 75,000 |  |
| Allowance for depreciation-building |  | \$ 15,000 |
| Furniture and fixtures | 30,000 |  |
| Allowance for depreciation-furniture and fixtures |  | 10,800 |
| Mortgage payable-ABC Life Insurance Company |  | 53,000 |
| Capital-Partner-Catron |  | 28,265 |
| Capital-Partner-Johnson |  | 28,265 |
| Room income |  | 17,249 |
| Wages | 3,545 |  |
| Advertising and supplies | 2,755 |  |
| Repairs and utilities | 2,234 |  |
| Office expense | 114 |  |
| Taxes | 166 |  |
| Depreciation | 3,770 |  |
| Interest | 405 |  |
|  | \$152,579 | \$152,579 |

Upon a careful inspection of details of the settlement between Catron and Johnson you learned that no adjustment for supplies, taxes, interest and insurance had been recorded on March 31, 1961.

The following transactions occurred on April 1, 1961 in the settlement:

1. The partnership bank account was closed by drawing equal checks payable to each partner.
2. Catron paid Johnson $\$ 235$ to be applied as follows:

One half of petty cash ................ \$ 50
One half of supplies inventory ...... 185
$\$ 235$
3. It was necessary for Catron to borrow additional funds on the motel property. Complete refinancing was worked out with the Second National Bank as set forth in the following disbursement statement prepared by the bank:

| Amount of loan from the Second National Bank | \$84,000 |
| :---: | :---: |
| Amount of check from Mr. Catron | 500 |
| Total | 84,500 |

Less:
Payoff of mortgage due ABC Life Insurance Company .................... $\$ 56,150$
Amount due Johnson \$28,950
Plus one-half unexpired fire insurance premium due Johnson, prorated April 1, 1961 to April 1, 1962; original premium was \$3,180 500 29,450
Less:
One-half penalty due ABC Insurance Company
\$1,325
One-half interest due ABC Insurance Company from February 6, 1961 to April 1, 1961 250
One-half real estate taxes from January 1, 1961 to April 1, 1961 150
Total . . . . . . . . . . . . . . . . . . . . . . . . . . . . $\quad$ 1,725
Amount due to Johnson
27,725 83,875
Total
625
Less financing costs
\$ 625
4. In addition Johnson accepted a $\$ 30,000$ second mortgage payable in equal monthly installments.
5. An appraisal of the motel property indicated the following values:

| Land | \$ 45,500 |
| :---: | :---: |
| Building | 78,000 |
| Furniture and fixtures | 18,200 |
| Total | \$141,700 |

## Required:

A worksheet with columns to show the following information:

1. Adjustments necessary to bring accounts into agreement with data as presented showing facts of dissolution agreement.
2. Income statement of the partnership for the period January 1, 1961 to March 31, 1961.
3. Balance sheet as of March 31, 1961.
4. Adjustments for dissolution.
5. Opening balances for Catron's books.

## GROUP II

(Estimated time- $\mathbf{4 0}$ to 60 minutes)
(Solve one of the two problems in this group.
If both are solved, only the first will be considered.)

## Number 5

The Dearborn Company manufactures product $\mathbf{X}$ in standard batches of 100 units. A standard cost system is in use. The standard costs for a batch are as follows:

| Raw materials | 60 lbs . @ $\$ .45$ per lb. | $\$ 27.00$ |
| :--- | ---: | ---: |
| Direct labor | 36 hrs @ $\$ 2.15$ per hr. | 77.40 |
| Overhead | $36 \mathrm{hrs}$. @ $\$ 2.75$ per hr. | 99.00 |
|  |  | $\$ 203.40$ |
|  |  |  |

Production for April 1960 amounted to 210 batches. The relevant statistics follow:

Standard output per month 24,000 units
Raw materials used
Cost of raw materials used
Direct labor cost 13,000 lbs.

Overhead cost \$ $6,110.00$

Average overhead rate per hour \$16,790.40
\$20,592.00
$\$ 2.60$
The management has noted that actual costs per batch deviate somewhat from standard costs per batch.

## Required:

Prepare a statement which will contain a detailed explanation of the difference between actual costs and standard costs.

## Number 6

The following information pertains to the operations of the General Fund of the X County. Functions of this county government include operating the county jail and caring for the county courts.

Funds to finance the operations are provided from a levy of county tax against the various towns of the county, from the state distribution of unincorporated business taxes, from board of jail prisoners assessed against the towns and against the state and from interest on savings accounts.

The balances in the accounts of the fund on January 1, 1960 were as follows:

$$
\text { Cash in savings accounts . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . \$ } 60,650
$$

Cash in checking accounts . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 41,380
Cash on hand (undeposited prisoners' board receipts) ......... 320
Inventory of jail supplies . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 3 3,070
Due from towns and state for board of prisoners . . . . . . . . . . . . . . 3,550
General Fund surplus . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 108,970
The budget for the year 1960 as adopted by the county commissioners provided for the following items of revenue and expenditure:
(1) Town and county taxes . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . \$ 20,000
(2) Jail operating costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 55,500
(3) Court operating costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 7,500
(4) Unincorporated business tax . . . . . . . . . . . . . . . . . . . . . . . . . . 18,000
(5) Board of prisoners (revenue) . . . . . . . . . . . . . . . . . . . . . . . . . . . 5,000
(6) Commissioners' salaries and expenses . . . . . . . . . . . . . . . . . . . . . 8,000
(7) Interest on savings . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 1,000
(8) Miscellaneous expenses . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 1,000

General Fund surplus was appropriated in sufficient amount to balance the budget. At December 31, 1960 the jail supply inventory amounted to $\$ 5,120$, cash of $\$ 380$ was on hand, and $\$ 1,325$ of prisoners' board bills were unpaid. The following items represent all of the transactions which occurred during the year, with all current bills vouchered and paid by December 31, 1960:

During the year, $\$ 25,000$ was transferred from the savings accounts to the checking accounts.

## Required:

From the above information, prepare a worksheet providing columns to show:
a. The transactions for the year. (Journal entries not required.)
b. Variances between budgeted and actual revenues and expenditures for the year.
c. Balance sheet of the General Fund, December 31, 1960.

## EXAMINATION IN AUDITING

May 18, 1961; 8:30 a.m. to $12: 00 \mathrm{~m}$.
(All questions are required.)

## Number 1 (Estimated time- 15 to 20 minutes)

You are making an examination of the accounts of the Hardy Corporation. Accounts receivable represent a significant proportion of the total assets of the company. At the beginning of the audit you mailed out positive confirmations on a test basis. Included in your test were confirmations requested from several United States Government departments; the confirmation requests for these accounts were returned along with the following notation:

Your confirmation letter is returned herewith without action inasmuch as the type of information requested therein cannot be compiled by this office with sufficient accuracy to be of any value.
Your test also included customers whose accounts payable systems were either decentralized or a voucher system which made it impossible or impractical to give the requested information. These customers either informed you of their inability to comply with the request or did not reply.

## Required:

a. Assuming the number and amount of responses to confirmation requests are unsatisfactory, what additional auditing procedures would you apply?
b. If satisfaction is obtained by these procedures, what effect, if any, would your difficulties with the examination of receivables have on your report?

Number 2 (Estimated time- $\mathbf{3 0}$ to 35 minutes)
You have been engaged for the audit of the $Y$ Company for the year ended December 31, 1960. The Y Company is engaged in the wholesale chemical business and makes all sales at $25 \%$ over cost.

Shown below are portions of the client's sales and purchases accounts for the calendar year 1960:

Sales

| Date | Reference | Amount | Date | Reference | Amount |
| :---: | :---: | :---: | :---: | :---: | :---: |
| 12/31 | Closing entry | \$699,860 | Balanc | ard | \$658,320 |
|  |  |  | 12/27 | SI\#965 | 5,195 |
|  |  |  | 12/28 | SI\#966 | 19,270 |
|  |  |  | 12/28 | SI\#967 | 1,302 |
|  |  |  | 12/31 | SI\#969 | 5,841 |
|  |  |  | 12/31 | SI\#970 | 7,922 |
|  |  |  | 12/31 | SI\#971 | 2,010 |
|  |  | \$699,860 |  |  | \$699,860 |

Purchases

| Date | Reference | Amount | Date | Reference | Amount |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Balance forward |  | \$360,300 | 12/31 | Closing entry | \$385,346 |
| 12/28 | RR\#1059 | 3,100 |  |  |  |
| 12/30 | RR\#1061 | 8,965 |  |  |  |
| 12/31 | RR\#1062 | 4,861 |  |  |  |
| 12/31 | RR\#1063 | 8,120 |  |  |  |
|  |  | \$385,346 |  |  | \$385,346 |
| $R \mathrm{R}=$ Receiving report <br> SI $=$ Sales invoice |  |  |  |  |  |

You observed the physical inventory of goods in the warehouse on December 31, 1960 and were satisfied that it was properly taken.

When performing a sales and purchases cutoff test, you found that at December 31, 1960 the last receiving report which had been used was No. 1063 and that no shipments had been made on any sales invoices with numbers larger than No. 968. You also obtained the following additional information:

1. Included in the warehouse physical inventory at December 31, 1960 were chemicals which had been purchased and received on receiving report No. 1060 but for which an invoice was not received until 1961. Cost was $\$ 2,183$.
2. In the warehouse at December 31, 1960 were goods which had been sold and paid for by the customer but which were not shipped out until 1961. They were all sold on sales invoice No. 965 and were not inventoried.
3. On the evening of December 31, 1960 there were two cars on the Y Company siding:
a. Car \#AR38162 was unloaded on January 2, 1961, and received on receiving report No. 1063. The freight was paid by the vendor.
b. Car \#BAE74123 was loaded and sealed on December 31, 1960, and was switched off the Company's siding on January 2, 1961. The sales price was $\$ 12,700$ and the freight was paid by the customer. This order was sold on sales invoice No. 968.
4. Temporarily stranded at December 31, 1960 on a railroad siding were two cars of chemicals enroute to the Z Pulp and Paper Co. They were sold on sales invoice No. 966 and the terms were F.O.B. destination.
5. Enroute to the Y Co. on December 31, 1960 was a truckload of material which was received on receiving report No. 1064. The material was shipped F.O.B. destination and freight of $\$ 75$ was paid by the Y Co. However, the freight was deducted from the purchase price of $\$ 975$.
6. Included in the physical inventory were chemicals exposed to rain in transit and deemed unsalable. Their invoice cost was $\$ 1,250$ and freight charges of $\$ 350$ had been paid on the chemicals.

## Required:

a. Compute the adjustments which should be made to the client's physical inventory at December 31, 1960.
b. Prepare the auditor's worksheet adjusting entries which are required as of December 31, 1960.

## Number 3 (Estimated time- $\mathbf{1 5}$ to 20 minutes)

You are newly engaged by the James Co., a New England manufacturer with a sales office and warehouse located in a western state. The James Co. audit must be made at the peak of your busy season when you will not have a senior auditor available for travel to the western outlet. Furthermore the James Co. is reluctant to bear the travel expenses of an out-of-town auditor.

## Required:

a. Under what conditions would you, the principal auditor, be willing to accept full responsibility for the work of another auditor?
b. What would be your requirements with respect to the integrity of the other auditor? To whom would you direct inquiries about the other auditor?
c. What reference, if any, would you make to the other auditor in your report if you were:
(1) Assuming full responsibility for his work?
(2) Not assuming responsibility for his work?

## Number 4 (Estimated time- 20 to 25 minutes)

The Generous Loan Company has 100 branch loan offices. Each office has a manager and four or five subordinates who are employed by the manager. Branch managers prepare the weekly payroll, including their own salaries, and pay employees from cash on hand. The employee signs the payroll sheet signifying receipt of his salary. Hours worked by hourly personnel are inserted in the payroll sheet from time cards prepared by the employees and approved by the manager.

The weekly payroll sheets are sent to the home office along with other accounting statements and reports. The home office compiles employee earnings records and prepares all federal and state salary reports from the weekly payroll sheets.

Salaries are established by home office job-evaluation schedules. Salary adjustments, promotions and transfers of full-time employees are approved by a home office salary committee based upon the recommendations of branch managers and area supervisors. Branch managers advise the salary committee of new full-time employees and terminations. Part-time and temporary employees are hired without referral to the salary committee.

## Required:

a. Based upon your review of the payroll system, how might funds for payroll be diverted?
b. Prepare a payroll audit program to be used in the home office to audit the branch office payrolls of the Generous Loan Company.

## Number 5 (Estimated time- 20 to 25 minutes)

When you arrive at your client's office on January 11, 1961 to begin the December 31, 1960 audit, you discover the client had been drawing checks as creditors' invoices became due but not necessarily mailing them. Because of a working capital shortage some checks may have been held for two or three weeks.

The client informs you that unmailed checks totaling $\$ 27,600$ were on hand at December 31, 1960. He states these December-dated checks had been entered in the cash disbursements book and charged to the respective creditors' accounts in December because the checks were prenumbered. Heavy collections permitted him to mail the checks before your arrival.

The client wants to adjust the cash balance and accounts payable at December 31 by $\$ 27,600$ because the cash account had a credit balance. He objects to submitting to his bank your audit report showing an overdraft of cash.

## Required:

a. Submit a detailed audit program indicating the procedures you would use to satisfy yourself of the accuracy of the cash balance on the client's statements.
b. Discuss the propriety of reversing the indicated amount of outstanding checks.

## Number 6 (Estimated time- $\mathbf{2 0}$ to 30 minutes)

Jiffy Clerical Services is a corporation which furnishes temporary office help to its customers. Billings are rendered monthly based on predetermined hourly rates. You have examined the company's financial statements for several years. Following is an abbreviated statement of assets and liabilities on the cash basis as of December 31, 1960.

| Assets |  |
| :---: | :---: |
| Cash | \$20,000 |
| Advances to employees. | 1,000 |
| Equipment and autos, less allowance for depreciation | 25,000 |
| Total assets | 46,000 |

Liabilities
Employees' income taxes withheld ..... 8,000
Bank loan payable ..... 10,000
Estimated federal income taxes on cash basis profits ..... 10,000
Total liabilities ..... 28,000
Net assets ..... \$18,000
Represented by:
Common stock ..... \$ 3,000
Cash profits retained in the business . ..... 15,000$\$ 18,000$
Unrecorded receivables were $\$ 55,000$ and payables were $\$ 30,000$.

## Required:

a. Prepare the opinion you would issue covering the statement of assets and liabilities as of December 31, 1960, as summarized above, and the related statement of cash income and expenses for the year ended that date.
b. Briefly discuss and justify your modifications of the conventional opinion on accrual basis statements.

## Number 7 (Estimated time - $\mathbf{2 0}$ to $\mathbf{3 0}$ minutes)

In your audit of the Longmont Company you prepared a schedule of notes receivable. This company, a manufacturer, does not have many notes receivable and therefore does not keep a note register. All notes have resulted from sales to customers. The following schedule was prepared:

## Column

Number
1.
2.
3.
4.
5.
6.
7.
8.
9.
10.
11.
12.
13.
14.
15.

## Column Heading

Name of maker
Names of endorsers
Date of note
Due date
Principal
Interest rate
Discounted (To the bank)
Date
Rate
Amount of discount
Interest
Collected
Accrued
Prepaid
Payment on principal
Balance due
Collateral held

## Required:

Draw a line down the middle of a lined sheet( $s$ ) of paper.
a. On the left of the line state the specific source(s) of information to be entered in each column and, where required, how data of previous columns are combined.
b. On the right of the line state the principal way(s) that such information would be verified.

## Number 8 (Estimated time- 15 to 25 minutes)

Describe the audit steps that would generally be followed in establishing the propriety of the recorded liability for federal income taxes of an established corporation which you are auditing for the first time. Consideration should be given the status of (a) the liability for prior years and (b) the liability arising from the current year's income.

## EXAMINATION IN COMMERCIAL LAW

May 19, 1961; 8:30 a.m. to $12: 00 \mathrm{~m}$.

(All questions are required.)

## Number 1 (Estimated time- $\mathbf{1 5}$ to 25 minutes)

You are to select all of those phrases which state a correct legal conclusion based on general principles of law and provisions of the law of contracts. Indicate your selection by placing an " X " in the appropriate column provided on an answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select the correct answers will be penalized.

1. A contract for the sale of a motorcycle to a minor can be enforced by:
a. The minor.
b. The other party against the minor.
c. Both parties.
d. The other party against the minor's parents.
e. None of the above.
2. Assuming that the terms of the following contracts were reasonable in all respects, the following provisions could be enforced against a minor:
a. A lease of lodgings to be used by the minor during the next school term.
b. Employment of a janitor to care for an apartment building owned by the minor.
c. Rent due on a house used as a dwelling for the minor and his wife.
d. Purchase of food-the minor lives with his parents who support him.
e. None of the above.
3. Assuming that the contract is one which a minor may disaffirm, his election may be made:
a. Only while he is still a minor.
b. Only during a reasonable time after reaching his majority.
c. Only within a reasonable time after making the contract.
d. At any time.
e. None of the above.
4. A minor will be deemed to have validly disaffirmed a contract:
a. Only if he expressly informs the other party to that effect.
b. Only if he obtains an order of a court to that effect.
c. If he expressly disaffirms the sale of real property during his minority.
d. If he fails to affirm before he reaches his majority.
e. None of the above.
5. If a minor wishes to disaffirm a contract for the purchase of luxury goods which is reasonable and fair in all respects:
a. He must return all of the goods.
b. He must return all of the goods which he may possess at the time of his disaffirmance.
c. He must pay the reasonable value of goods he actually consumed or from which he received benefits.
d. He must return only those goods which he desires to return.
e. None of the above.
6. A minor who has purchased a motorcycle on the installment plan will be deemed to have affirmed the purchase, if after he has reached his majority:
a. He retains the motorcycle and continues to use it for six months.
b. He fails to disaffirm at that time.
c. He signs a new note for the balance.
d. He promises orally to pay the balance due.
e. None of the above.
7. A minor purchasing a motorcycle on the installment plan, representing to the seller that he was of legal age, and having the appearance of one who was at least 23:
a. May effectively plead his minority as a defense to a suit for the balance of the purchase price.
b. Will be deemed to have waived his right to disaffirm.
c. Will be required to restore, so far as possible, what he has received if he seeks to recover the amount paid in equity.
d. Will be liable for any resulting damage based upon a tort action of deceit.
e. None of the above.
8. A person who seeks to avoid a contract on grounds that he was intoxicated when the contract was made must:
a. Establish only that he was sufficiently intoxicated to affect his judgment.
b. Establish that he was sufficiently intoxicated to be incapable of understanding the consequences of his acts.
c. Actively disaffirm within a reasonable time after regaining sobriety and learning of the contract terms.
d. Establish that the other party used fraud or deceit to gain his assent to the contract terms.
e. None of the above.
9. One who is insane may effectively plead insanity as a complete defense to a contract for luxuries:
a. Even though the other party executed the contract in good faith, not knowing of the insanity, and cannot be restored to his former position.
b. If the contract is still executory.
c. If made after he has been adjudicated insane and a guardian has been appointed by a competent court.
d. If actually insane at the time of the making, although not so adjudicated, and the seller was aware of the insanity.
e. None of the above.
10. The following promises in an otherwise valid contract would be enforceable:
a. All of the gasoline I desire at $33 \phi$ per gallon.
b. All of the gasoline I desire during the next 60 days at $33 \phi$ per gallon.
c. All of the gasoline I need during the next year at $33 \phi$ per gallon.
d. All of the gasoline I need at $33 \phi$ per gallon, with a right of cancellation by either party upon written notice.
e. None of the above.
11. A promise to refrain from suing on a claim will constitute adequate consideration for an otherwise valid contract:
a. If the claim is bona fide.
b. Only if suit has actually been started to enforce the claim.
c. Only if the claim is related to a valid business transaction.
d. Even though the claim is legally not enforceable, but the claimant honestly believes that he can recover thereon.
e. None of the above.
12. A promise to pay a sum which is greater than that required by an existing contract will be enforced in the following circumstances:
a. The date for payment is postponed one week.
b. A builder states that he will complete the construction only if compensated for difficulties which were not foreseen at time of making the contract.
c. A builder at the owner's request agrees that he will complete the construction a day ahead of the time called for under the contract.
d. Both parties agree to cancel the old contract and make a new one.
e. None of the above.
13. A gratuitous assignment of contract rights will become irrevocable:
a. If the assignee receives payment in accordance with the assignment terms.
b. If the assignee obtains a judgment based on the assigned rights.
c. If the assignee materially changes his position in reliance on the assignment.
d. If the assignee gives notice of the assignment to the other party to the contract.
e. None of the above.
14. The following rights may be effectively assigned by the owner:
a. A claim against the U. S. Government.
b. Future salary payments of a public official.
c. A tort claim.
d. A judgment.
e. None of the above.
15. The following situations would result in an assignment of the designated rights of X to B :
a. X promises to assign a $\$ 25.00$ account receivable to $\mathbf{B}$.
b. A check, drawn by X, payable to B would assign a portion of X's account with the bank.
c. $\mathbf{X}$ hands his savings passbook to B, saying, "Here is a present for you."
d. X makes an otherwise effective assignment orally.
e. None of the above.

## Number 2 (Estimated time- 15 to 25 minutes)

You are to select all of those phrases which state a correct legal conclusion based on general principles of corporation law. Indicate your selection by placing an " X " in the appropriate column provided on the answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select correct answers will be penalized.

1. The creation of a corporation:
a. Is, in effect, the grant of a franchise or privilege by the state.
b. May be accomplished by an act of Congress.
c. May be accomplished by a special act of the legislature.
d. In America today, is largely accomplished pursuant to individual states' general corporation acts.
e. None of the above.
2. Concerning preincorporation contracts made by promoters:
a. The promoter is personally liable upon contracts made on behalf of the corporation, in the absence of any agreement to the contrary.
b. Adoption of the contract by the corporation automatically releases the promoter.
c. The corporation generally assumes liability on the contract by ratifying the act of the promoter-agent.
d. Liability for the corporation will result either from an express adoption or by accepting the benefits of the preincorporation contract.
e. None of the above.
3. A corporation can qualify as a de facto corporation:
a. Despite the fact that the statute under which it is created is later held to be unconstitutional.
b. If it, among other things, has made a "colorable compliance" with the requirements of law.
c. Despite the fact that there has been a conscious failure to file the articles or certificate of incorporation in the office of the secretary of state or elsewhere as prescribed.
d. Only if there has been an assumption or use of corporate powers.
e. None of the above.
4. The directors of a corporation:
a. May validly give a proxy to one of their members to cast at a board meeting.
b. When acting as a board are the agents for the corporation.
c. When acting in their individual capacities as directors will bind the corporation.
d. Are not entitled to compensation for their services as directors unless there was prior authorization.
e. None of the above.
5. Directors of a corporation will be personally liable for:
a. Diversion of corporate opportunities to others.
b. Honest errors of judgment.
c. Declarations of dividends which they know will impair legal capital.
d. Lack of reasonable care.
e. Breach of fiduciary duty.
6. Statutes frequently declare that certain general powers, known as inherent powers, shall be incident to all corporations created under the act; among these are:
a. The authority to adopt and amend bylaws.
b. The authority to adopt a corporate seal.
c. The authority to purchase shares of stock of other corporations.
d. The authority to sue and be sued in the corporate name.
e. The power to purchase, hold and convey real property in the corporate name.
7. In the absence of express authorization or special circumstances, a corporation cannot:
a. Sign a negotiable instrument as an accommodation indorser.
b. Become a general partner.
c. Purchase shares of stock of other corporations.
d. Execute negotiable instruments.
e. Enter into a joint venture with another party.
8. The law regarding ultra vires contracts is as follows:
a. Neither party will be required to perform if the contract is executory on both sides.
b. Most courts treat them as a nullity but allow recovery in quasi contract.
c. Most courts permit recovery by the party other than the corporation, if there has been a performance by that party, whereas, the corporation may not recover under the ultra vires contract even though it was fully performed.
d. The courts will not interfere to deprive either party of what has been acquired under an ultra vires contract if it is fully executed on both sides.
e. None of the above.
9. The separate corporate entity will be disregarded if:
a. One man owns all the shares of stock.
b. There is a parent-subsidiary relationship between two corporations.
c. It was used to effect a fraud.
d. It is used for the purpose of obtaining limited liability.
e. None of the above.
10. As an owner of common stock in a corporation you have the right:
a. To vote for the president of the corporation.
b. To have annual dividends declared.
c. To subscribe proportionately to newly authorized issues of shares before they are offered to the public.
d. To join with others in a voting trust for the purpose of electing favored directors.
e. None of the above.
11. A preincorporation subscription to shares of stock in a corporation to be formed:
a. Need not be in writing.
b. Is treated as a continuing offer which may be revoked before the corporation is formed.
c. Is deemed accepted in many jurisdictions upon the corporation's coming into existence without further formalities.
d. Will not be binding on the subscriber until he receives actual notice of acceptance from the newly-created corporation.
e. None of the above.
12. Treasury stock:
a. May be sold for less than original par without liability to the purchaser in the event of insolvency.
b. Is subject to the pre-emptive right of existing shareholders.
c. Is voted by the directors at stockholders' meetings.
d. Is stock that was originally issued but subsequently reacquired by the corporation.
e. Normally cannot be acquired by the corporation if the acquisition would result in an impairment of legal capital.
13. Preferred stock:
a. Is impliedly cumulative unless otherwise indicated.
b. Is always preferred as to dividends.
c. Will be voting stock, with the same voting rights as common, unless specifically classified as nonvoting.
d. Can have rights equal or superior to the rights of creditors to payment of their claims.
e. None of the above.
14. A dividend duly declared:
a. Becomes a debt of the corporation.
b. Cannot be revoked even if it is in fraud of creditors.
c. Can validly be revoked if it is revoked at the same meeting at which it was declared.
d. Can validly be revoked if it is a stock dividend and the stock has not been issued.
e. Can validly be revoked if it is payable in the future and the declaration has not been made public.
15. A stockholder has the right to inspect the books of the corporation in order to:
a. Obtain a list of stockholders to solicit proxies to oust existing management.
b. Obtain the names of stockholders in order to compile advertising lists.
c. Ascertain the financial status of the corporation.
d. Obtain information to aid him in litigation against the directors.
e. Secure business prospects for another corporation.

## Number 3 (Estimated time- $\mathbf{1 5}$ to $\mathbf{2 5}$ minutes)

You are to select all of those phrases which state a correct legal conclusion based on general principles of suretyship and guaranty. Indicate your selection by placing an " $X$ " in the appropriate column provided on the answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select correct answers will be penalized.

1. Regarding capacity to act as a surety:
a. The general rules as to capacity to contract are applicable insofar as individuals are concerned.
b. It is normally ultra vires for a corporation to so act.
c. A partnership ordinarily has this right.
d. Individual partners generally do not have capacity to bind the partnership as a surety.
e. None of the above.
2. A noncompensated surety on a debt can avoid liability if he can show:
a. Death of the principal debtor.
b. His promise was obtained through the fraud of the principal debtor.
c. A modification that can only be beneficial to the surety.
d. A material alteration by the creditor in the instrument expressing the contract of the principal debtor.
e. None of the above.
3. Both the principal debtor and the surety will be able to avoid liability if:
a. The principal debtor obtains a discharge in bankruptcy.
b. There is a release of the principal debtor by the creditor.
c. There is a tender of performance by the principal debtor.
d. There is a tender of performance by the surety.
e. There is lack of capacity of the principal debtor.
4. The right of subrogation:
a. Will only be available where the creditor has been satisfied.
b. Means that the surety, in addition to the rights he may have against the debtor personally, succeeds to the rights the creditor has.
c. Will not apply to security held by the creditor.
d. Is not available to a guarantor of collection.
e. None of the above.
5. Regarding the surety's right of reimbursement or indemnity:
a. The statute of limitations begins to run against this right in favor of the principal debtor from the date of his default.
b. The surety may be permitted to recover an amount in excess of his payment in satisfying the creditor.
c. The right will not be affected by a release of the principal debtor by the creditor.
d. The right is lost if a cosurety relationship exists.
e. None of the above.
6. Where there is collateral pledged with the surety, the creditor:
a. Does not have any rights therein prior to default.
b. Has the right to have the collateral used to satisfy the principal debt after default.
c. May choose to disregard the collateral even though it would be sufficient to satisfy the principal debt, and proceed immediately against the surety.
d. Has a right to collateral even though it was pledged with an intent only to benefit the surety.
e. None of the above.
7. Where there is collateral pledged with the creditor, the surety:
a. Will be released pro tanto if there is a release of all or part of the collateral by the creditor.
b. Under ordinary circumstances, has the right to demand that the creditor resort to the collateral if it is sufficient to satisfy the debt.
c. Has no right prior to default to demand that the creditor deliver it to him.
d. Will have no right to the collateral until the creditor has been completely satisfied.
e. None of the above.
8. In order to establish a cosurety relationship the parties must be:
a. Bound to answer for the same duty of the principal debtor.
b. Bound for the same amount.
c. Aware of the other surety's existence at the time of contracting.
d. Financially acceptable to each other.
e. None of the above.
9. The cosurety's right to contribution:
a. Is not affected by a release by the creditor of a cosurety with a reservation of rights against the other cosurety.
b. Will be available when a cosurety pays more than his proportionate share of the obligation.
c. Will, normally, in the final settlement of accounts, be affected by any collateral he uses for his reimbursement.
d. Will be diminished by an appropriate portion of the value of any collateral he surrenders to the principal debtor.
e. None of the above.
10. The statute of limitations in a surety relationship:
a. Will begin to run in favor of the surety from the time of default.
b. Will not be extended or revived insofar as the surety is concerned by a subsequent part payment by the principal debtor.
c. Will not run in favor of a principal debtor who fraudulently prevents discovery of the default.
d. In regard to contribution, reimbursement and liability to the creditor, will begin to run from the same instant of time.
e. None of the above.
11. The following contracts must be in writing within the meaning ot the Statute of Frauds:
a. Contracts of indemnity.
b. Performance bonds, fidelity bonds and judicial bonds.
c. Promises to answer for the debt or default of another.
d. A promise to sign a written surety contract.
e. None of the above.
12. As a general rule of suretyship, where the surety has not consented:
a. A binding extension of time will allow the noncompensated surety to avoid the obligation.
b. A release of the principal debtor by the creditor, with a reservation of rights against the surety, will release the surety.
c. A binding modification of the principal obligation will release the noncompensated surety.
d. A change in the duties, that is, an increase in responsibility, of a party under a fidelity bond will release the compensated surety.
e. A substitution of parties releases the surety.
13. In a subsurety relationship:
a. There is no right of contribution as between the principal surety and the subsurety.
b. The ultimate liability as between the sureties rests with the subsurety.
c. The subsurety will have a right of reimbursement.
d. Release of the subsurety releases the principal surety.
e. None of the above.
14. If the surety agrees only to guarantee collection (a type of conditional guaranty) then:
a. Notice of default must be given to the surety.
b. The surety will only be liable if a judgment is returned unsatisfied.
c. The normal rules of suretyship apply and the surety is immediately liable upon default.
d. A binding extension of time will not release the surety.
e. The bankruptcy of the principal debtor will release the surety.
15. In respect to the creditor, the surety has the right to set off personal claims that:
a. He has against the creditor even though they did not arise out of the suretyship relation.
b. He has against the principal debtor.
c. He has against the creditor, but only those claims which arose out of the suretyship relation.
d. The principal debtor has against the creditor if the principal debtor is insolvent.
e. None of the above.

## Number 4 (Estimated time- 15 to 25 minutes)

You are to select all of those phrases which state a correct legal conclusion based on general principles of agency law. Indicate your selection by placing an " $X$ " in
the appropriate column provided on the answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select the correct answers will be penalized.

1. Which of the following phrases is correctly associated with the relationship between an agent and his principal?
a. Created by a manifestation of assent.
b. Subject to another's control.
c. Power to change another's legal relationship.
d. Independent contractor.
e. Fiduciary.
2. An agent can bind:
a. An undisclosed principal.
b. A nonexistent principal.
c. A minor principal.
d. A disclosed principal.
e. A corporate principal.
3. A special agent is an agent who among other things:
a. Is authorized to conduct a single or limited number of transactions.
b. Lacks continuity of service.
c. Has greater apparent authority than a general agent.
d. Has authority equal to a limited partner.
e. Acts for an undisclosed principal rather than a disclosed principal.
4. In determining the scope of the apparent authority of an agent the following factors would be considered:
a. The custom or usages of the business.
b. The express limitations on the agent's authority but which are unknown to third parties.
c. Acquiescence by the principal in previous similar acts.
d. The status of agent's position in the principal's business.
e. Whether or not a sales agent has possession of the goods.
5. Where a party is given an exclusive agency to sell specified property:
a. The principal can compete with the agent.
b. The principal can appoint other agents to accomplish the sale.
c. The agent has the same rights as an agent given the exclusive right to sell.
d. The agency is irrevocable because it is coupled with an interest.
e. The creation of the exclusive agency must be in writing.
6. The appointment of another agent or a subagent by an agent:
a. Is strictly limited because of the personal relationship with the principal.
b. Cannot be made if the agency calls for the use of discretion.
c. Can only be made by express authorization.
d. Can be inferred from the custom of the business.
e. Will be inferred if the authorized transaction cannot lawfully be performed by the agent in person.
7. An agency relationship may be created:
a. Only by a written authorization.
b. By an express or implied authorization.
c. By estoppel.
d. Orally.
e. By operation of law.
8. $\mathbf{P}$ is an infant who has expressly appointed his father, $\mathbf{A}$, as agent. A makes a contract with $T$ indicating that he, $A$, is acting as an agent for $P$, but without disclosing that $\mathbf{P}$ is a minor. Based on these facts:
a. T may recover against $\mathbf{A}$ and $\mathbf{P}$.
b. T may recover against $P$ only.
c. T may recover against neither party.
d. T may recover against A only.
e. T is liable on the contract with $\mathbf{P}$.
9. In order to have a valid ratification by the principal:
a. The agent must have been given some authority, even though it is exceeded.
b. The principal must be an undisclosed principal at the time of the making of the contract.
c. The ratification must be in writing.
d. He need not be aware of all the material facts at the time he ratifies.
e. The third person must not have withdrawn from the transaction.
10. The death of the principal:
a. Terminates the agency relationship and the authority of the agent to bind the principal as soon as the agent learns of the death.
b. Terminates the agency relationship immediately, but does not terminate the authority to bind the principal until notice is received.
c. Immediately terminates the agency relationship and the agent's power to bind the principal.
d. Will result in liability for the agent if he makes a contract unaware of the principal's death.
e. Will terminate the agent's power to bind the principal but will impose liability on the principal's estate if the agent and a third party contract unaware of the death.
11. Notification of termination of an agent's authority:
a. Will be effective as to all parties upon agent's receipt of written notification.
b. Will be effective as to all parties if published in a newspaper of widespread circulation.
c. Will be effective only against those parties who are aware of the termination if published in a newspaper of widespread circulation.
d. Must come from the principal if it is to be effective.
e. None of the above.
12. After principal has appointed and the agent has agreed to act as principal's irrevocable agent for three years:
a. Such an agency is irrevocable by either party within the three year period.
b. Such an agency is subject to either party's power to revoke it.
c. This would be an example of an agency coupled with an interest.
d. If either party revokes within the three years he will be liable for breach of contract.
e. The parties could mutually agree to rescind the agency relationship at any time.
13. An agent who is acting for an undisclosed principal:
a. Will bind not only the principal but also himself on most contracts.
b. Will bind only the principal if he disclosed the principal's identity immediately after making the contract.
c. Will be the only one bound if he executes a negotiable instrument.
d. Will bind the third party to the contract with the undisclosed principal.
e. Will not be able to bind the third party because there has been a fraud.
14. An agent who makes fraudulent representations to a third party:
a. Is liable to the third party regardless of whether or not he is acting within the scope of his express authority.
b. Will have a right to indemnity regardless of whether or not he was acting within the scope of his authority.
c. Will have a right of indemnity only if acting within the scope of his authority and he is unaware of his tortious conduct.
d. Is liable to the third party only if he is acting outside the scope of his authority.
e. None of the above.
15. An agent whose principal violates his contractual duty to the agent may:
a. Maintain an action at law.
b. Obtain a decree for an accounting.
c. Refuse to render further service.
d. Exercise the rights of a lien holder as to principal's property in his possession.
e. None of the above.

## Number 5 (Estimated time- 15 to 25 minutes)

a. David, who bore a remarkable physical resemblance to Frank, one of the town's most prominent citizens, presented himself one day at the Friendly Finance Company, represented himself as Frank and requested a loan of $\$ 500$. The manager mistakenly, but honestly, believed that David was Frank and accordingly, being anxious to please so prominent a citizen, required no collateral and promptly delivered to David a $\$ 500$ check payable to the order of Frank. David took the check and signed Frank's name to it on the back and negotiated it to Harold who took in the ordinary course of business (in good faith and for value). Upon learning the real facts, Friendly Finance Company stopped payment of the check. Harold now seeks recovery against the Friendly Finance Company.

## Required:

1. Can Harold collect on the negotiable instrument against the Friendly Finance Company? Explain.
2. What right of action does Friendly Finance Company have against David? Explain.
b. $\mathbf{Y}$ holds a negotiable instrument made out to his order which he transfers to $\mathbf{X}$ for value. $Y$ forgot to endorse his name on the back and $X$ did not notice the omission.

## Required:

1. What is the effect of the transfer? Explain.
2. When, if ever, will $X$ become a holder in due course?

## Number 6 (Estimated time- 15 to 25 minutes)

Jay took his best suit to the Spotless Dry Cleaners to have it altered, cleaned and pressed. He delivered the suit to the manager and received a receipt in which the suit was described, the work to be performed indicated and the charge shown. A week later Jay returned to the store, presented his receipt and asked for his suit. The manager searched the racks, but was unable to find it. He asked Jay to return in a few days as he thought the suit had not yet been returned or had been misplaced. The manager contacted the cleaning plant and the suit could not be located; in fact, their records indicated it had been returned to the store with other garments. The manager diligently searched through all the clothing in the store and questioned all his employees but to no avail. Jay returned five days later, presented the receipt, tendered the amount due and demanded the suit. The manager explained that the suit had just disappeared and that neither he nor any of his employees had taken it nor knew what happened to it, therefore, he was not liable.

## Required:

a. What is the legal relationship between the owner of the suit and Spotless Dry Cleaners? Explain.
b. What responsibility does the relationship impose upon Spotless Dry Cleaners as to the safekeeping of the suit? Explain.
c. Based solely upon the facts stated who will prevail in the event of a lawsuit in which both parties prove only the facts indicated? Explain.
d. Suppose there had been an accidental fire in the store which destroyed the suit and Spotless could prove that the fire had started through no fault of its own, would this change your answer? Explain.
e. Assuming that the suit had been found and Jay demands its return but does not tender any money in payment of the charges, can Spotless retain the suit? If so, on what grounds? Explain.

## Number 7 (Estimated time- 20 to 30 minutes)

a. Tom ordered 1,000 pairs of cordovan shoes from the Bunion Shoe Company. The terms were F.O.B. X Railroad at seller's railroad siding. The Bunion Shoe Company packed and delivered the 1,000 pairs of shoes to the $\mathbf{X}$ Railroad. During the transportation of the shoes to Tom, torrential rains caused widespread flooding and water seeped into the boxcar carrying the shoes. As a result, the shoes were discolored and damaged in other respects.

## Required:

1. The buyer refuses to accept the goods and claims that the risk of loss remained with the seller. Is he correct? Explain.
2. Suppose the party having the risk of loss sues the $X$ Railroad, can he recover? Explain.
3. Assuming that the subject matter was valuable furs and that the cargo was hijacked by armed robbers, would the railroad be liable? Explain.
b. Jerry wishes to purchase twenty radios for his appliance store. He went to the Hi-tone Radio Company and they proceeded to show him some samples. Jerry considered one of the samples an excellent buy at the price. The sample shown had some obvious imperfections in the finish and in addition, would only play on alternating current whereas most radios could play on either alternating or direct current. There was a sticker on the back of the radio indicating that it should not be used with direct current without a converter. Jerry examined the radio, listened to its tone, range, and volume, and decided he couldn't pass up the opportunity at that price.
The rural area in which Jerry's store was located used direct current. When Jerry received the radios they all had imperfect finishes and were in all other ways exactly like the sample he inspected. When he plugged one in the socket, it blew several tubes.

## Required:

1. Which warranties (other than those expressly stated and the implied title warranties) arise in sales transactions? List them.
2. Which of the implied warranties, if any, has been breached here? Explain.

## Number 8 (Estimated time- 20 to 30 minutes)

Andy consults Bill about the possibility of borrowing $\$ 10,000$ from him. Bill replies that he will be happy to make the loan if Andy will put up some collateral to secure repayment. Andy delivers $\$ 12,000$ worth of convertible bearer bonds, with coupons attached, to Bill and also gives him his promissory note for $\$ 10,000$. During the period in which the loan is outstanding the bonds rose in value to $\$ 18,000$, and in addition, one of the coupons became due and Bill has it in his possession. There is no express agreement between the parties as to rights of the parties regarding the interest or profits.

## Required:

a. What is the type of security device that has been availed of by the parties? Define.
b. Upon what does it depend for its validity? Explain.
c. Andy repays the loan in full. Bill claims that he has the right to the accrued profits and the interest payments on the bonds which arose during the time he holds them. Does he have this right or any rights in respect to the profit and interest? Explain.
d. In such a transaction, where security has been given for the obligation, what are the rights of the creditor upon default? Explain.

# EXAMINATION IN THEORY OF ACCOUNTS 

## May 19, 1961; 1:30 to 5:00 p.m.

(All questions are required.)

## Number 1 (Estimated time- 25 to 35 minutes)

You are to select from the alternatives presented, all of those which correctly complete each of the following numbered statements. Indicate your selection by placing an " $X$ " in the appropriate column provided on an answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select the correct answers will be penalized.

1. Consolidated statements are used to present the result of operations and the financial position of:
a. A company and its branches.
b. A company and its subcontractors.
c. A company and its subsidiaries.
d. Any group of companies with related interests.
e. None of the above.
2. Consolidated statements are intended, primarily, for the benefit of:
a. Stockholders of the parent company.
b. Taxing authorities.
c. Management of the parent company.
d. Creditors of the parent company.
e. None of the above.
3. A consolidated statement for $\mathbf{X}, \mathbf{Y}$ and $\mathbf{Z}$ is proper if:
a. $\mathbf{X}$ owns $100 \%$ of the outstanding common stock of $\mathbf{Y}$ and $49 \%$ of $\mathbf{Z}$; Q owns $51 \%$ of Z .
b. X owns $100 \%$ of the outstanding common stock of $\mathbf{Y} ; \mathbf{Y}$ owns $75 \%$ of $\mathbf{Z}$.
c. $X$ owns $100 \%$ of the outstanding common stock of $Y$ and $75 \%$ of Z . X bought the stock of Z one month before the statement date, and sold it six weeks later.
d. There is no interrelation of financial control among $\mathbf{X}, \mathbf{Y}$ and $\mathbf{Z}$. However, they are contemplating the joint purchase of $100 \%$ of the outstanding common stock of W .
e. X owns $100 \%$ of the outstanding common stock of Y and $\mathrm{Z} . \mathrm{Z}$ is in bankruptcy.
4. H is the parent company and would probably treat K as an investment and not a consolidated subsidiary in the proposed consolidated statement of $\mathrm{H}, \mathrm{J}$ and K if:
a. H and J manufacture electronic equipment; K manufactures ball bearings.
b. H and J manufacture ball-point pens; K is a bank.
c. $K$ has assets of $\$ 1,000,000$ and an outstanding bond issue of $\$ 750,000$. H holds the bonds.
d. Same as $c$, except that outsiders hold the bonds.
e. None of the above.
5. Parent company $P$ has a fiscal year ending June 30, 1961. Subsidiary S's fiscal year ends May 31, 1961. Therefore:
a. A consolidated statement cannot properly be prepared for $\mathbf{P}$ and $\mathbf{S}$.
b. S's May 31, 1961 statement can be used for consolidation with P's June 30, 1961 statement, provided disclosure (or some recognition) is made of any June event which materially affected $S$.
c. If the consolidated statement is permissible, it will be dated June 30, 1961.
d. If the consolidated statement is permissible, it will be dated May 31, 1961.
e. None of the above.
6. In preparing consolidated statements, elimination is necessary for:
a. Net (intercompany) profit or loss on assets remaining within the group.
b. Gross (intercompany) profit or loss on assets remaining within the group.
c. Net (intercompany) profit or loss on transactions with subsidiaries not consolidated; the investment being carried at cost.
d. Gross (intercompany) profit or loss on transactions with subsidiaries not consolidated; the investment being carried at cost.
e. None of the above.
7. P owns $90 \%$ of the stock of S. W owns $10 \%$ of S's stock. In relation to $\mathbf{P}$, W is considered as:
a. An affliate.
b. A subsidiary not to be consolidated.
c. A minority interest.
d. A holding company.
e. None of the above.
8. The cost of a parent company's investment in a subsidiary exceeded its equity in the book value of the subsidiary's net assets at the acquisition date. The parent company made the investment because of the subsidiary's ownership of valuable patents which were carried on its books at net cost, $\$ 1,000$. In the consolidated statements, the excess of the parent's cost over its equity in the book value of the subsidiary's net assets should be shown as:
a. An increase in patents.
b. Goodwill.
c. Excess of book value over purchase price.
d. Surplus from consolidation.
e. None of the above.
9. P's cost of investment in $M$ exceeded its equity in the book value of M's net assets at the acquisition date. The excess is not attributable to specific assets. In the consolidated statements, this excess should be:
a. Eliminated.
b. Allocated proportionately to the subsidiary's fixed assets.
c. Shown on the balance sheet as surplus from consolidation.
d. Shown on the balance sheet as excess of cost of stock of subsidiary over book value.
e. None of the above.
10. P's cost of investment in $J$ was less than its equity in the book value of J's net assets at the acquisition date. The difference is related to the decline in value of J's machinery. In the consolidated statements, this difference should be shown on the balance sheet as:
a. A reduction in machinery.
b. Capital surplus.
c. Surplus from consolidation.
d. Excess of book value over purchase price.
e. None of the above.
11. Company $\mathbf{P}$ purchased the outstanding common stock of $S$ as follows:

10\%, January 2, 1960
25\%, June 1, 1960
$25 \%$, August 1, 1960
$40 \%$, September 30, 1960
The fiscal year of each of the companies ends on September 30. S's stock was acquired by $\mathbf{P}$ at book value. Consolidated net income for the fiscal year ended September 30, 1960 would include the following earnings of the subsidiary:
a. $10 \%$ of earnings, January - May, 1960.
b. $35 \%$ of earnings, June - July, 1960.
c. $60 \%$ of earnings, August - September, 1960.
d. $60 \%$ of earnings, January - September, 1960.
e. None of the above.
12. Company $\mathbf{P}$ had 300,000 shares of stock outstanding. It owned $75 \%$ of the outstanding stock of T. T owned 20,000 shares of P's stock. In the consolidated balance sheet, Company P's outstanding stock may be shown as:
a. 280,000 shares.
b. 300,000 shares less 20,000 shares of treasury stock.
c. 300,000 shares.
d. 300,000 shares footnoted to indicate that T holds 20,000 shares.
e. None of the above.
13. Company $P$ and its subsidiary $S$ filed separate income tax returns. P's tax included $\$ 70,000$ attributable to profits on sales to $S$. In preparing consolidated financial statements:
a. The entire intercompany profit should be eliminated; taxes need not be adjusted.
b. Taxes of $\$ 70,000$ should be deferred.
c. The intercompany profit should be reduced by $\$ 70,000$ before elimination, and taxes of $\$ 70,000$ should be deferred.
d. Income taxes should be recomputed, and a revised return should be filed.
e. None of the above.
14. Combined financial statements are justified for the following:
a. A group of subsidiaries not consolidated.
b. Corporations engaged in similar or related operations, owned by the same (individual) stockholder.
c. A group of companies under common management.
d. Any group of companies with related interests.
e. None of the above.
15. The preferable method of presenting subsidiaries not consolidated in financial statements is:
a. At market value, adjusted through income.
b. At market value, adjusted through retained earnings.
c. At cost, plus the parent's share of the subsidiaries' net income (or minus the net loss), since acquisition, adjusted annually through income.
d. At cost, plus the parent's share of the subsidiaries' net income (or minus the net loss), adjusted annually through retained earnings.
e. At consolidated group's equity in net realizable value of assets of subsidiaries not consolidated.
16. It is acceptable accounting treatment to carry investments in subsidiaries not consolidated at cost:
a. Under no circumstances.
b. With dividends included in income as received.
c. Less provision for any permanent material impairment of the investment.
d. If there is disclosure, by footnote or otherwise, of the equity of the consolidated group in the net assets of subsidiaries not consolidated.
e. None of the above.
17. "Negative goodwill" is:
a. Not acceptable terminology for statement purposes.
b. Subtracted from goodwill, if any, for statement purposes.
c. Synonomous with surplus from consolidation.
d. Also known as excess of book value over purchase price.
e. None of the above.
18. Company P owns $75 \%$ of the outstanding common stock of S. During 1960, P's profits on its transactions with $S$ amounted to $\$ 50,000$. The elimination for intercompany profit is:
a. Not necessary.
b. $\$ 50,000$.
c. $\$ 37,500$.
d. Allocated between Company P and the minority stockholders.
e. None of the above.
19. $\mathbf{P}$ and its subsidiaries, $\mathbf{T}$ and V , have issued combined statements for a number of years. In connection with a proposed bank loan, P has been requested to present a statement to the bank which will indicate P's financial position at December 31, 1960. The following will supply the desired information:
a. A copy of the consolidated statement at December 31, 1960.
b. A copy of P's financial statement at December 31, 1960 on which the investments in T and V are reported at the current carrying value.
c. A copy of the consolidated statement and of the separate parent company (P) statement, both at December 31, 1960.
d. A copy of the consolidated statement at December 31, 1960, modified so that one column is used for P and others columns for T and V .
e. A copy of separate financial statements of $\mathrm{P}, \mathrm{T}$ and V as of December 31, 1960.
20. The stockholders of S sold all of its common stock, 1,000 shares, to Company P , receiving in return 5,000 shares of Company P stock. On the day prior to the sale, P stock sold for $\$ 40$ per share; S stock sold for $\$ 195$ per share. P stock has a par value of $\$ 20$ per share. S stock has a par value of $\$ 50$ per share.

The investment by $\mathbf{P}$ may be recorded on its books at:
a. $\$ 200,000$, only.
b. $\$ 195,000$, only.
c. $\$ 100,000$.
d. $\$ 50,000$.
e. Either $\$ 200,000$ or $\$ 195,000$.

## Number 2 (Estimated time- 10 to 15 minutes)

The president of a small factory has come to you for advice. His bookkeeper tells him each year that the business has been just about breaking even. He said that the inventories, receivables and payables have not varied much since the corporation was organized ten years ago but that cash has been constantly increasing. He thinks that the business has been making money and that there is an error. The president stated there has been no sale of assets, refinancing of indebtedness, or change in corporate structure such as sale of stock.

## Required:

a. Present briefly the explanation that you would give the president for the continued increase in cash.
b. Give examples of transactions that would illustrate your explanation.
c. What financial statements would you prepare for the president?

## Number 3 (Estimated time- 10 to 15 minutes)

Cal-York Airline is converting from piston-type planes to jets. Delivery time for the jets is three years during which period substantial progress payments must be made. The multimillion dollar cost of the planes cannot be financed from working
capital; Cal-York must borrow funds for the payments.
Because of high interest rates and the large sum to be borrowed, management estimates that interest costs in the second year of the period will be equal to one third of net income before interest and taxes, and one half of such income in the third year.

After conversion, Cal-York's passenger-carrying capacity will be doubled with no increase in the number of planes, although the investment in planes would be substantially increased. The jet planes have a seven-year service life.

## Required:

Give your recommendation concerning the advisability of capitalizing the interest during the conversion period. Support your recommendation with reasons and suggested accounting treatment. (Disregard federal income tax implications.)

## Number 4 (Estimated time- 15 to 25 minutes)

You have been requested by the newly formed E-Z Construction Company to assist them in determining the desirable method of accounting for income from operations. The company undertakes the long-term, large-scale type of construction and is engaged with only two or three contracts at one time.

## Required:

a. Briefly describe the desirable method of accounting for income from operations. Give the advantages and disadvantages of the method selected.
b. Give an alternative method of accounting for income and state why this method is not preferred under the circumstances.

## Number 5 (Estimated time- 20 to 30 minutes)

At year end the following accounts appeared in the general ledger of the Lucien Corporation:

1. Reserve for Service Guarantees.
2. Reserve for Plant Depreciation.
3. Reserve for Foreign Earnings.
4. Reserve for Replacement of LIFO Inventory.

## Required:

a. Describe briefly the nature and purpose of these accounts. Indicate in which sections of the balance sheet these accounts should be displayed.
b. Give an alternative title for any of the accounts which you believe are improperly titled. Indicate briefly your reasons for the title changes.

## Number 6 (Estimated time- 20 to 30 minutes)

You are engaged in the audit of the Willis Corporation which opened its first branch office in 1960. During the audit the Willis president raises the question of the accounting treatment of the branch office operating loss for its first year, which is material in amount.

The president proposes to capitalize the operating loss as a "starting-up" expense to be amortized over a five-year period. He states that branch offices of other firms engaged in the same field generally suffer a first-year operating loss which is invariably capitalized, and you are aware of this practice. He argues, therefore, that the loss should be capitalized so that the accounting will be "conservative"; further, he argues that the accounting must be "consistent" with established industry practice.

## Required:

a. Discuss the president's use of the words "conservative" and "consistent" from the standpoint of accounting terminology. Discuss the accounting treatment you would recommend.
b. What disclosure, if any, would be required in the financial statements?

## Number 7 (Estimated time- $\mathbf{2 0}$ to 30 minutes)

The Board of Directors of a mining corporation, foreseeing a three to five-year period of reduced operations, has decided to invest its liquid funds during this period in a diversified list of common stocks (all listed on the New York Stock Exchange) rather than pay as much in dividends as is legally permissible. The directors further decide to include such investments in their annual financial statements on a current market value basis.

## Required:

a. What advantage may be attributed to this method of reporting such investments?
b. What objections might be offered to this method?
c. How should these securities be presented in financial statements?

## Number 8 (Estimated time- 20 to 30 minutes)

a. In some instances accounting principles require a departure from valuing inventories at cost alone. Determine the proper unit inventory price in the following cases:

| $C$ A S E S |  |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: |
|  | 1 | 2 | 3 | 4 | 5 |
| Cost $\ldots \ldots \ldots \ldots \ldots \ldots \ldots \ldots$ | $\$ 2.00$ | $\$ 2.00$ | $\$ 2.00$ | $\$ 2.00$ | $\$ 2.00$ |
| Net realizable value $\ldots \ldots \ldots \ldots \ldots$ | 1.30 | 2.05 | 1.80 | 2.40 | 1.90 |
| Net realizable value less normal profit | 1.10 | 1.85 | 1.60 | 2.20 | 1.70 |
| Market (replacement cost) $\ldots \ldots \ldots$. | 1.20 | 2.10 | 1.85 | 2.15 | 1.60 |

b. Assume the item in Case 5 is also in stock at the end of the next fiscal period and the four values are respectively $\$ 2.00, \$ 1.90, \$ 1.70$ and $\$ 2.05$. What would be the proper unit price?
c. Normally inventory values include cost of freight in. Under certain circumstances, however, these costs are excluded from determination of inventory cost.
(1) Indicate the circumstances under which this exclusion might be practiced and comment on the propriety of the exclusion.
(2) Without discussion, list other costs which might similarly be excluded from inventory cost.

# EXAMINATION IN ACCOUNTING PRACTICE—PART I 

## November 8, 1961; 1:30 to 6:00 p.m. <br> (All problems are required.)

## Number 1 (Estimated time- $\mathbf{3 0}$ to $\mathbf{4 5}$ minutes)

Place an " X " in the appropriate column of an answer sheet for each of the following questions. The answers should be selected in accordance with the Internal Revenue Code and Regulations.

1. The president of the Ball Corporation accepts 100 shares of $\$ 100$ par value common stock, held as treasury stock, as a bonus. The treasury stock, which had been reacquired by the Ball Corporation at $\$ 90$ per share nine months earlier, had a market value of $\$ 95$. The bonus and transfer of stock should be handled as:
a. Business expense of $\$ 9,000$.
b. Business expense of $\$ 9,500$.
c. Business expense of $\$ 10,000$.
d. Business expense of $\$ 10,000$; capital gain of $\$ 1,000$.
e. None of the above.
2. Assume that the Ball Corporation exchanges the treasury stock referred to in " 1 " above for property with a fair market value of $\$ 10,000$. The tax basis of the property received and the tax treatment of the exchange should be handled as:
a. Basis of $\$ 9,000$; no capital gain or loss.
b. Basis of $\$ 9,500$; no capital gain or loss.
c. Basis of $\$ 10,000$; capital gain of $\$ 1,000$.
d. Basis of $\$ 10,000$; capital gain of $\$ 500$.
e. None of the above.
3. A corporation owned securities which it acquired for $\$ 200,000$ in 1958 . The securities were distributed to its stockholders in 1960 when the market value was $\$ 250,000$. For 1960 the corporation would report:
a. Ordinary income of $\$ 50,000$.
b. Long-term capital gain of $\$ 50,000$.
c. Short-term capital gain of $\$ 50,000$.
d. Ordinary loss of $\$ 50,000$.
e. None of the above.
4. A corporation moved its manufacturing operations. An obsolete specialized machine, with an adjusted basis of $\$ 5,000$, was sold as scrap for $\$ 500$ because it was not worth moving. The corporation's profit from operations for the year was $\$ 100,000$. The corporation's taxable income is:
a. $\$ 100,500$.
b. $\$ 95,500$.
c. $\$ 100,000$ with a capital loss carryover of $\$ 4,500$.
d. $\$ 100,500$ with a capital loss carryover of $\$ 5,000$.
e. None of the above.
5. A corporation issued 1,000 shares of $\$ 100$ par value preferred stock at par in 1950 redeemable at $\$ 110$ at any time. The stock was redeemed in 1960. In 1960 the corporation would report:
a. Long-term capital loss of $\$ 10,000$.
b. Short-term capital loss of $\$ 10,000$.
c. Loss to be offset against capital gains of $\$ 10,000$, at the election of the corporation.
d. Ordinary itemized deduction of $\$ 10,000$.
e. None of the above.
6. A corporation reporting a net operating loss for 1960 would exhaust the loss by applying it to other taxable years in the following sequence:
a. 1959, 1958, 1957, 1961, 1962, 1963, 1964, 1965.
b. 1957, 1958, 1959, 1961, 1962, 1963, 1964, 1965.
c. $1959,1958,1957,1956,1955,1961,1962,1963$.
d. $1955,1956,1957,1958,1959,1961,1962,1963$.
e. None of the above.
7. A corporation showed a loss of $\$ 75,000$, before special deductions, on its tax return for 1960. Dividend income of $\$ 1,000$ from domestic corporations was included in gross income in the preparation of the return. For carry-back purposes, the net operating loss is:
a. $\$ 75,000$.
b. $\$ 75,850$.
c. $\$ 74,150$.
d. $\$ 76,000$.
e. $\$ 74,000$.
8. A corporation spent $\$ 370,000$ on an advertising campaign in December 1960 that will benefit the next three years. The deduction for 1960 would be:
a. $\$ 1,000$.
b. $\$ 92,500$.
c. $\$ 123,333$.
d. $\$ 370,000$.
e. None of the above.
9. A cash-basis taxpayer borrowed $\$ 1,000$ from a bank on August 1, 1960. The interest for one year at $6 \%$ was deducted in advance. His interest deduction for 1960 would be:
a. $\$ 25.00$.
b. $\$ 30.00$.
c. $\$ 40.00$.
d. $\$ 60.00$.
e. None of the above.
10. Harry Jones filed a joint return with his wife. They have no dependents and claimed deductions of $\$ 1,000$. Their tax return for 1960 showed a $\$ 12,000$ loss after all deductions and exemptions. Jones' only source of income in 1960 was his hardware store. For carry-back or carry-over purposes, his net operating loss deduction is:
a. $\$ 12,000$.
b. $\$ 11,000$.
c. $\$ 10,800$.
d. $\$ 9,800$.
e. None of the above.
11. Assume the same facts as in " 10 " above except that Jones also had interest income of $\$ 300$ which was considered in arriving at the $\$ 12,000$ loss. For carryback or carry-over purposes, his net operating loss deduction is:
a. $\$ 12,000$.
b. $\$ 9,800$.
c. $\$ 10,800$.
d. $\$ 10,100$.
e. None of the above.
12. On November 15, 1960 A. Lumnus gave 100 shares of General Electron stock to his alma mater, State University, as a contribution. The stock, which had a market value of $\$ 1,500$ on the date of contribution, was purchased by A. Lumnus on April 1, 1960 for $\$ 800$. Assuming no other factors or limitations, A. Lumnus is entitled to a contribution deduction of:
a. $\$ 700$.
b. $\$ 800$.
c. $\$ 1,500$.
d. $\$ 750$.
e. None of the above.
13. Assuming the facts in "12" above, A. Lumnus must report a long-term capital gain of:
a. $\$ 700$.
b. $\$ 800$.
c. $\$ 1,500$.
d. $\$ 750$.
e. None of the above.
14. After learning that State University had immediately sold the 100 shares of General Electron stock, A. Lumnus on December 15, 1960 requested his broker to sell another 100 shares at the same market price of $\$ 1,500$. A. Lumnus then forwarded his personal check to State University for the $\$ 1,500$. These shares were purchased on April 1, 1960, for $\$ 800$ also. Assuming no other factors or limitations, A. Lumnus is entitled to a contribution deduction of:
a. $\$ 700$.
b. $\$ 800$.
c. $\$ 1,500$.
d. $\$ 750$.
e. None of the above.
15. Assuming the same facts as in " 14 " above, A. Lumnus must report:
a. Long-term capital gain of $\$ 700$.
b. Short-term capital gain of $\$ 700$.
c. Long-term capital gain of $\$ 1,500$.
d. Short-term capital gain of $\$ 1,500$.
e. None of the above.

Place an " X " in the appropriate column on an answer sheet indicating whether or not each of the following statements is correct.
16. The amount of real estate taxes paid to a taxing authority by a tenant under terms of a lease is taxable income to the landlord.
17. Payment to a tenant by a landlord for cancellation of a lease of a personal residence in effect for more than six months is taxable as ordinary income to the tenant.
18. A leasehold improvement made by a tenant is taxable as ordinary income to the landlord to the extent of its fair market value when the lease expires.
19. Excessive rent paid by a corporation to one of its stockholders would be construed to be a dividend.
20. A lease agreement between family members, even though it places income in a lower-income tax bracket, is valid if the rental terms are consistent with an arm's length transaction.
21. Rentals from real estate are excluded from an individual's self-employment income.
22. An advance rental payment covering more than one year must be prorated by the tenant over the period to which the payment applies.
23. Advance rental income covering more than one year must be prorated by the landlord over the period to which the payment applies.
24. In determining the reasonableness of compensation for officers, the amount of sales of the corporation is more important than the amount of profits.
25. When an excessive salary is paid to an officer who is a large stockholder, the deduction is disallowed the corporation and the recipient treats the amount as return of capital.
26. Income on sinking fund investments held by a trustee are excluded from the taxable income of the contributing corporation.
27. An individual engaged in two separate and distinct businesses may report one on a cash basis and one on an accrual basis.
28. An individual receiving shares of stock in payment of services defers reporting income until sale of the stock.
29. An individual filing for less than one year because of a change in his taxable year must prorate his exemptions.
30. Cash patronage dividends received from a cooperative on account of purchases of farm supplies by a farmer are tax-exempt income.
31. A taxpayer stores valuable family silverware with a jeweler for safekeeping. Such expense is deductible as an ordinary and necessary expense for the preservation of property.
32. A dividend declared payable on December 31 and mailed that day is December income by constructive receipt to a cash-basis taxpayer.
33. Payment of a normally deductible item with borrowed money is not deductible by a cash-basis taxpayer until the loan is repaid.
34. If a cash-basis taxpayer gives his note in payment of a normally deductible item, he cannot take the deduction until the note is paid.
35. A newly organized corporation may file its return on a fiscal year basis without applying for permission.

## Number 2 (Estimated time- 20 to 35 minutes)

You are preparing your long form report in connection with the examination of State Gas Company at December 31, 1960. The report will include an explanation of the 1960 increase in operating revenues.

The following information is available from the company records:

|  | 1959 | 1960 | $\begin{aligned} & \text { Increase } \\ & \text { (Decrease) } \end{aligned}$ |
| :---: | :---: | :---: | :---: |
| Average number of customers | 27,000 | 26,000 | $(1,000)$ |
| MCF sales | 486,000 | 520,000 | 34,000 |
| Revenue | \$1,215,000 | \$1,274,000 | \$59,000 |

## Required:

To explain the 1960 increase in operating revenues, prepare an analysis accounting for the effect of changes in:

1. Average number of customers.
2. Average gas consumption per customer.
3. Average rate per MCF sold (MCF = thousand cubic feet).

## Number 3 (Estimated time- 25 to 35 minutes)

The Blank Corporation, which uses the conventional retail inventory method, wishes to change to the last-in, first-out retail method beginning with the accounting year ending December 31, 1960.

Amounts as shown by the firm's books are as follows:

|  | At Cost | At Retail |
| :---: | :---: | :---: |
| Inventory, January 1, 1960 | \$ 5,210 | \$ 15,000 |
| Purchases in 1960 | 47,250 | 100,000 |
| Mark-ups in 1960 |  | 7,000 |
| Mark-downs in 1960 |  | 2,000 |
| Sales in 1960 |  | 95,000 |

You are to assume that all mark-ups and mark-downs apply to 1960 purchases, and that it is appropriate to treat the entire inventory as a single department.

## Required:

Compute the inventory at December 31, 1960 under:
a. Conventional retail method.
b. Last-in, first-out retail method, effecting the change in method as of January 1, 1960.

## Number 4 (Estimated time- 50 to 70 minutes)

The Neversink Corporation advises you that it is facing bankruptcy proceedings. As the company's CPA you are aware of its condition.

The balance sheet of the Neversink Corporation at June 30, 1961 and supplementary data are presented below:

| Assets |  |
| :---: | :---: |
| Cash | \$ 2,000 |
| Accounts receivable, less allowance for bad debts | 70,000 |
| Inventory, raw material | 40,000 |
| Inventory, finished goods | 60,000 |
| Marketable securities | 20,000 |
| Land | 13,000 |
| Buildings, less allowance for depreciation | 90,000 |
| Machinery, less allowance for depreciation | 120,000 |
| Goodwill | 20,000 |
| Prepaid expenses | 5,000 |
| Total assets | \$440,000 |
| Liabilities and Capital |  |
| Accounts payable | \$80,000 |
| Notes payable | 135,000 |
| Accrued wages | 15,000 |
| Mortgages payable | 130,000 |
| Common stock | 100,000 |
| Retained earnings (deficit) | $(20,000)$ |
| Total liabilities and capital | \$440,000 |

Supplementary data:

1. Cash includes a $\$ 500$ travel advance which has been expended.
2. Accounts receivable of $\$ 40,000$ have been pledged in support of bank loans of $\$ 30,000$. Credit balances of $\$ 5,000$ are netted in the accounts receivable total.
3. Marketable securities consisted of government bonds costing $\$ 10,000$ and 500 shares Bartlett Company stock. The market value of the bonds is $\$ 10,000$ and the stock is $\$ 18$ per share. The bonds have accrued interest due of $\$ 200$. The securities are collateral for a $\$ 20,000$ bank loan.
4. Appraised value of raw materials is $\$ 30,000$ and finished goods is $\$ 50,0000$. For an additional cost of $\$ 10,000$, the raw materials would realize $\$ 70,000$ as finished goods.
5. The appraised value of fixed assets is: land, $\$ 25,000$; buildings, $\$ 110,000$; machinery, $\$ 75,000$.
6. Prepaid expenses will be exhausted during the liquidation period.
7. Accounts payable include $\$ 15,000$ withheld payroll taxes and $\$ 6,000$ creditors who had been reassured by the president they would be paid. There are unrecorded employer's payroll taxes in the amount of $\$ 500$.
8. Wages payable are not subject to any limitations under bankruptcy laws.
9. Mortgages payable consist of $\$ 100,000$ on land and buildings, and $\$ 30,000$ chattel mortgage on machinery. Total unrecorded accrued interest for these mortgages amounted to $\$ 2,400$.
10. Estimated legal fees and expenses in connection with the liquidation are $\$ 10,000$.
11. Probable judgment on a pending damage suit is $\$ 50,000$.
12. You have not rendered an invoice for $\$ 5,000$ for last year's audit and you estimate a $\$ 1,000$ fee for liquidation work.

## Required:

a. Prepare a statement of affairs.
b. Compute the estimated settlement per dollar of unsecured liabilities.

## Number 5 (Estimated time- $\mathbf{6 0}$ to 85 minutes)

The Ecton Company proposes to sell all of its assets except Cash and Receivables to the Jones Company on July 31, 1961. The sales price shall be $\$ 10,000,000$ adjusted by the change in book value from December 31, 1960 to May 31, 1961 for Inventories and Property. The May 31 book values of Prepaid Expenses and Other Assets are to be added to the sales price.

The settlement shall be:

1. Jones Company $4 \%$ note for $\$ 3,000,000$ payable in semiannual installments of $\$ 150,000$ commencing January 31,1962 ;
2. Assumption of all liabilities except the Estimated Federal Income Taxes Payable and Long-Term Debt;
3. Balance payable in cash immediately.

The company intends to retire the preferred stock and establish a $\$ 300,000$ reserve for contingencies. The net profit for June and July is estimated at $\$ 150,000$ before taxes (assume that a $50 \%$ tax rate has been in effect since 1956).

The last preferred stock dividend was declared on December 31, 1960. The regular common stock dividend was paid on June 15, 1961.

Taxable income for the past four years follows:

| 1957 | $\$ 1,481,000$ |
| :--- | ---: |
| 1958 | 412,400 |
| 1959 | 639,600 |
| 1960 | 842,500 |

Presented below are balance sheets for December 31, 1960 and May 31, 1961:

## Ecton Company

## BALANCE SHEETS

| Assets | December 31, 1960 | May 31, 1961 |
| :---: | :---: | :---: |
| Cash | \$ 1,038,000 | \$ 472,000 |
| Receivables | 2,550,000 | 3,105,000 |
| Inventories | 5,592,000 | 6,028,000 |
| Prepaid expenses | 308,000 | 297,000 |
| Total Current Assets | 9,488,000 | 9,902,000 |
| Property (net) | 6,927,000 | 6,804,000 |
| Other assets | 635,000 | 604,000 |
| Total Assets | \$17,050,000 | \$17,310,000 |


| Liabilities and Capital D | December 31, 1960 | May 31, 1961 |
| :---: | :---: | :---: |
| Accounts payable | \$ 2,427,000 | \$ 3,052,500 |
| Current maturities-long-term debt | 600.000 | 600,000 |
| Accrued liabilities | 1,096,000 | 922,000 |
| Dividends payable-preferred stock | 63,000 | 0 |
| Estimated federal income taxes | 417,000 | 333,500 |
| Total Current Liabilities | 4,603,000 | 4,908,000 |
| Long-term debt | 4,200,000 | 4,050,000 |
| Stockholders' Equity: |  |  |
| Preferred cumulative stock - 21,000 shares of $\$ 100$ par, $3 \%$, outstanding. Redeemable at $\$ 102$ | g. $2,100,000$ | 2,100,000 |
| Common stock - 100,000 shares of \$10 par outstanding | of $1,000,000$ | 1,000,000 |
| Capital contributed in excess of par value of common stock | . 587,000 | 587,000 |
| Retained earnings . . . . . . . . . . . . . . . | . 4,560,000 | 4,665,000 |
| Total Liabilities and Capital | \$17,050,000 | \$17,310,000 |

Note: The increase in Retained Earnings is net of a dividend of $\$ .20$ per share paid March 15, 1961 on common stock.

## Required:

a. Compute the total sales price and settlement to be made.
b. Compute Ecton Company's gain or loss on the sale giving effect to income taxes.
c. Prepare a worksheet with column headings "Per Books," "Adjustments" and "Estimated Balance Sheet, July 31, 1961" giving effect to the proposed sale and other information given. Support your adjustments with schedules or computations you deem necessary. Formal journal entries are not required.

# EXAMINATION IN ACCOUNTING PRACTICE-PART II 

November 9, 1961; 1.30 to 6:00 p.m.

## GROUP I

## (Solve all problems in this group.)

## Number 1 (Estimated time- $\mathbf{3 0}$ to $\mathbf{4 0}$ minutes)

The Specialties Co., Inc. is engaged in manufacturing and wholesaling two principal products. As their accountant, you have been asked to advise management on sales policy for the coming year.

Two different plans are being considered by management, either of which, they believe, will (1) increase the volume of sales, (2) reduce the ratio of selling expense to sales, and (3) decrease unit production costs. These proposals are as follows:

## Plan 1-Premium Stamp Books

It is proposed that each package of Product A will contain 8 premium stamps, and each package of Product B will contain 4 premium stamps. Premium stamp books will be distributed to consumers, and when a book is filled with stamps ( 100 stamps) it will be redeemed by the award of a cash prize in an amount indicated under an unbroken seal attached to the book at the time of distribution. Every 10,000 books distributed will provide for prizes in accordance with the following schedule:

| Number of books | Prize for each | Total prizes |
| :---: | :---: | :---: |
|  | $\$ 150.00$ | $\$ 150$ |
| 5 | 50.00 | 250 |
| 14 | 20.00 | 280 |
| 50 | 10.00 | 500 |
| 160 | 5.00 | 800 |
| 1,020 | 1.00 | 1,020 |
| 8,750 | .40 | 3,500 |
| 10,000 |  | $\$ 6,500$ |

This schedule is fixed and not subject to alteration or modification. The cost of this plan will be as follows:

Books, including distribution cost Stamps
Prizes

[^0]The premium stamp book plan will take the place of all previous advertising, and previously established selling prices will be maintained.

## Plan 2—Reduced Selling Prices

It is proposed that the selling price of Product $A$ will be reduced by $81 / 3 \%$ and of Product B by $5 \%$ and to increase the advertising expenditures over those of the prior year. This plan is an alternative to Plan 1, and only one will be adopted.

Management has provided you with the following information as to the previous year's operations, and as to anticipated changes:

| Prior year's operations: | Product A | Product B |
| :---: | :---: | :---: |
| Quantity sold | 200,000 units | $\overline{600,000 ~ u n i t s}$ |
| Production cost per unit | \$. 40 | \$. 30 |
| Selling price per unit | \$. 60 | \$.40 |
| Selling expenses were $18 \%$ third was for advertising. were $5 \%$ of sales. |  |  |

Expected changes:
Increase in unit sales volume:
Plan 1 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $50 \%$ 50\%
Plan 2 ......................................... . . $40 \%$ 25\%
Decrease in unit production cost:
Plan 1 .......................................... . . . . $5 \%$ $10 \%$

Advertising
Plan 1 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . None None
Plan 2 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $\mathbf{8 \%}$ of sales $\mathbf{7 \%}$ of sales
Other selling expenses:
Plan 1 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $15 \%$ of sales $12 \%$ of sales
Plan 2 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $12 \%$ of sales $12 \%$ of sales
Premium book expenses:
Plan 1 ........................ . . . . . . . . . . . . . . . As indicated
Plan 2 ............................................. None None
Administrative expenses:
Plan 1 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $4 \%$ of sales $4 \%$ of sales
Plan 2 ........................................ . . Same dollar amount as prior year

## Required:

Prepare a schedule for submission to management comparing operations of the previous year with those under both proposed plans.

## Number 2 (Estimated time- $\mathbf{4 0}$ to 50 minutes)

The Master Engineering Corporation was formed by Harold Jones, Jack Smith and Tom Brown in 1958. Each incorporator contributed $\$ 15,000$ for 1,500 shares of common stock. A timely election was made by the company under Section 1372
to file as a "small business corporation" for the fiscal year ending December 31, 1960.

The corporation's net income on an accrual basis for 1960 was $\$ 27,500$. Included in the net income computation were:

1. Interest from State of Illinois Bonds, $\$ 1,000$.
2. Interest from United States Treasury Bills, $\$ 200$.
3. Dividends from domestic corporation, $\$ 2,000$.
4. Premiums paid on officers' life insurance, $\$ 1,500$.
5. Charitable contributions, $\$ 2,000$.
6. Long-term capital gain, $\$ 3,000$.

All three stockholders worked full time and each received a salary of $\$ 10,000$. In addition, the corporation paid a $\$ 3,000$ dividend to each stockholder on December 31, 1960. The dividend was paid from the current year's earnings.

Harold Jones prepares his personal tax return on a cash basis. The following information is available for his return:

1. His salary from Master Engineering was all received in 1960.
2. Dividends on savings account from the Federal Savings and Loan Association were $\$ 350$.
3. Short-term capital losses amounted to $\$ 400$.
4. Securities with a fair market value of $\$ 5,000$ were sold to a church for $\$ 3,000$, their cost to Mr. Jones.
5. Medical expenses for two minor children and his wife, Ethel, were $\$ 600$ for professional fees and $\$ 150$ for drugs and medicines.
6. His widowed mother, aged 75 , lived with the family. During the year she received $\$ 550$ interest on investments all of which was banked. Harold Jones paid all his mother's living expenses estimated to be $\$ 500$.
7. Dividends from securities included $\$ 75$ from the American Telephone Company and $\$ 150$ from the Consolidated Water Company of Mexico. The securities are jointly owned.
8. Pursuant to arrangement with the company in connection with his duties as outside salesman, he entertained customers at his home at an expense of $\$ 1,000$ for which he was not reimbursed.

## Required:

a. Prepare a schedule showing Harold Jones' taxable income for 1960.
b. Prepare a computation showing the determination of Harold Jones' basis in the stock of Master Engineering Corporation on January 1, 1961.

## Number 3 (Estimated time- $\mathbf{4 0}$ to 50 minutes)

Your client, who reports for accounting and tax purposes on the accrual basis, owns stock in only the New Jersey Investment Trust. In the process of auditing his accounts for the year ended December 31, 1960 your assistant prepared the following analysis of the Dividend Income account. The amounts recorded are receipts of cash.
Dividend Income
February 29 ..... \$ 6.72
April 25 ..... 354.31
July 25 ..... 322.10
October 25 ..... 45
Balance per books, December 31, 1960 ..... $\$ 683.58$

Your client has neither purchased nor sold any shares of New Jersey Investment Trust during 1960. It was established by confirmation from the client's broker that 3,183 shares of this stock were owned by the client on December 31, 1959 and 3,245 shares were owned on December 31, 1960.

You referred to the annual dividend declaration summary of the New Jersey Investment Trust, as reported in a national financial reporting service, and accumulated the following information:

## New Jersey Investment Trust <br> DIVIDEND DATA

Declared: February 12, to stockholder of record February 19, payable February 26 , a capital gain dividend of $\$ .14$ per share payable in cash or, at option of stockholder, in paid-up shares at $\$ 11.55$ per share, any fractional shares payable in cash.
April 1, to stockholder of record April 8, payable April 22, a regular dividend of $\$ .11$ per share.
July 1, to stockholder of record July 8, payable July 22, a regular dividend of $\$ .10$ per share.
October 7, to stockholder of record October 14, payable October 24, a capital gain dividend of $\$ .09$ per share payable in cash or at option of stockholder in paid-up shares at $\$ 12.06$ per share, any fractional shares payable in cash.
December 9, to stockholder of record December 16, payable January 3, 1961, a regular dividend of $\$ .11$ per share.

## Required:

a. Prepare an analysis which shows the number of New Jersey Investment Trust shares held by your client on January 1 and December 31, 1960 and accounts for the changes. Show your computations.
b. Prepare an analysis of client's 1960 income from New Jersey Investment Trust shares. Distinguish between capital gains and dividend income.
c. Prepare in general journal form any adjusting entries necessary as of December 31, 1960.

## Number 4 (Estimated time- $\mathbf{4 5}$ to 65 minutes)

The Biltimar Company manufactures gewgaws in three steps or departments. The Finishing Department is the third and last step before the product is transferred to finished goods inventory.

All material needed to complete the gewgaws is added at the beginning of the
process in the Finishing Department, and lost units, if any, occur only at this point. The company uses the FIFO cost method in its accounting system and has accumulated the following data for July for the Finishing Department:

1. Production of gewgaws: ..... Units
In process, July 1 (labor and manufacturing expense three-fourths complete) ..... 10,000
Transferred from preceding departments during July ..... 40,000
Finished and transferred to finished goods inventory dur- ing July ..... 35,000
In process, July 31 (labor and manufacturing expense one-half complete) ..... 10,000
2. Cost of work in process inventory, July 1:
Costs from preceding departments ..... \$ 38,000
Costs added in Finishing Department prior to July 1: Materials ..... 21,500
Labor ..... 39,000
Manufacturing expense ..... 42,000
Cost of work in process inventory, July 1 ..... \$140,5003. Gewgaws transferred to the Finishing Department duringJuly had costs of $\$ 140,000$ assigned from preceding de-partments.
3. During July, the Finishing Department incurred the fol-lowing production costs:Material\$ 70,000
Labor ..... 162,500
Manufacturing expense ..... 130,000
Total ..... \$362,500

## Required:

a. The cost of the gewgaws lost in production during July.
b. The cost of the gewgaws transferred to finished goods inventory in July.
c. The cost of the work in process inventory at July 31.

## GROUP II

## (Estimated time-45 to 65 minutes)

(Solve one of the two problems in this group. If both are solved, only the first will be considered.)

## Number 5

During 1960 the Products Company acquired a controlling interest in Designers, Inc. Trial balances of the companies at December 31, 1960 are presented on the
accompanying worksheet. The following information is available regarding the transactions and accounts of the companies:

1. An analysis of Investment in Designers, Inc.:

| Date | Description | Amount | Interest Acquired |
| :---: | :---: | :---: | :---: |
| January 1, 1960 | Investment | \$325,000 | 70\% |
| September 30, 1960 | Investment | 105,000 | 20\% |
| Total |  | 430,000 | 90\% |
| December 31, 1960 | 90\% of Designers, Inc. income for 1960 | 45,000 |  |
|  |  | \$475,000 |  |

The net income of Designers, Inc. for the nine months ended September 30, 1960 was $\$ 25,000$.
2. An analysis of the companies' Retained Earnings accounts:

|  | Products <br> Company | Designers, Inc. |
| :---: | :---: | :---: |
| Balance, January 1, 1960 | \$1,605,000 | \$400,000 |
| December 31, 1960: |  |  |
| Cash dividend declared <br> (payable January 15, 1961) |  | $(5,000)$ |
| 90\% of Designers, Inc. income for 1960 | 45,000 |  |
| Balance, December 31, 1960 | \$1,650,000 | \$395,000 |

3. The patents and licenses of Designers, Inc. have a fair market value of $\$ 25,000$.
4. On September 30, 1960, Products Company loaned its subsidiary $\$ 100,000$ on a $4 \%$ note. Interest and principal are payable in quarterly installments beginning December 31, 1960.
5. Designers, Inc. sales are principally engineering services billed at cost plus $50 \%$. During 1960, $\$ 40,000$ was billed to Products Company of which $\$ 16,500$ was treated as a deferred charge at December 31, 1960.
6. During the year parent company sales to the subsidiary aggregated $\$ 60,000$ of which $\$ 16,000$ remained in the inventory of Designers, Inc. at December 31, 1960.
7. In 1960 the parent company constructed certain tools at a cost of $\$ 15,000$ which were sold to Designers, Inc. for $\$ 25,000$. Designers, Inc. depreciates such tools using the straight-line method over a five-year life. One-half year's depreciation is provided in the year of acquisition.
Complete the worksheet below for consolidated statements. This is not a pooling of interests. Necessary adjusting and elim-
inating entries should be prepared in good form with explanations and supporting computations. Disregard income tax implications.
Debits

| Designers, <br> Inc. <br> 80,000 |
| ---: |
| 100,000 |
| 125,000 |
| 500,000 |
| 50,000 |
| 525,000 |
| 174,000 |
| 1,000 |
| $\$ 1,555,000$ |

80,000
75,000
5,000
150,000
100,000
395,000
750,000


| Products |
| ---: |
| Company |
| 100,000 |
| 100,000 |
| 200,000 |
| 1,000 |
| 924,000 |
| 475,000 |
| $1,250,000$ |
| 25,000 |
| $1,350,000$ |
| 251,000 |
| $\$ 4,676,000$ |



## Products Company and Subsidiary December 31, 1960

WORKSHEET FOR CONSOLIDATED STATEMENTS
Adjustments
and
Eliminations
$\begin{array}{r}\begin{array}{r}\text { Designers, } \\ \text { Inc. } \\ \text { 80,000 }\end{array} \\ \hline 100,000 \\ 125,000 \\ \\ 500,000 \\ \\ 50,000 \\ 525,000 \\ 174,000 \\ 1,000 \\ \hline \$ 1,555,000 \\ \hline\end{array}$

Cash
Retained
Earnings
Consolidated
Eliminations $\quad \begin{gathered}\text { Income } \\ \text { Statement }\end{gathered}$
Products
Company
100,000
200,000
1,000
924,000
475000
$1,250,000$
1,350,000

## Number 6

The Crescent City Council has employed you to examine the General Fund. The following information is made available to you directly or as the result of your examination:

1. The account balances of the General Fund at the end of the fiscal year are as follows:

| Debits |  |
| :---: | :---: |
| Cash | \$ 600,000 |
| Taxes Receivable-Current | 500,000 |
| Appropriation Expenditures | 9,300,000 |
|  | \$10,400,000 |

Credits

2. At the beginning of the year the Council formally approved the budget for the fiscal year. The budget is presented with the cash receipts and disbursements information in " 3 " below.
3. Cash receipts and disbursements, together with budgeting information, is presented below.

|  | Estimated Revenues | Actual Receipts |
| :---: | :---: | :---: |
| Taxes: |  |  |
| Current year | \$ 9,700,000 | \$9,500,000 |
| Collected in advance | 0 | 20,000 |
| Licenses and permits | 200,000 | 250,000 |
| Fines and forfeits | 70,000 | 78,000 |
| Rentals from use of properties | 30,000 | 32,000 |
| Miscellaneous: |  |  |
| Refunds and rebates of current service charges by other agencies: |  |  |
| Utility Fund | 0 | 6,000 |
| Working Capital Fund | 0 | 4,000 |
| Unused (excess) cash from Bond Fund | 0 | 10.000 |
| Total | \$10,000,000 | \$9,900,000 |


|  | Planned Expenditures | Actual Disbursements |
| :---: | :---: | :---: |
| Departmental expenses* | \$ 7,100,000 | \$6,894,000 |
| Contribution to Retirement Pension Fund | 150,000 | 140,000 |
| Creation of a petty cash fund | 0 | 5,000 |
| City's share of cost of special assessments | 150,000 | 150,000 |
| Establishment of Working Capital Fund | 50,000 | 50,000 |
| Equipment-general office | 420,000 | 421,000 |
| Land for building site | 500,000 | 500,000 |
| Sinking Fund contribution | 1,000,000 | 1,000,000 |
| Matured serial general obligation bonds | 100,000 | 100,000 |
| Interest on bonds: |  |  |
| Sinking Fund bonds | 20,000 | 20,000 |
| Serial bonds | 10,000 | 10,000 |
| Temporary loan to Working Capital Fund | 0 | 10,000 |
|  | \$ 9,500,000 | \$9,300,000 |
| *Include the following: |  |  |
| Billed by Utility Fund | \$ 70,000 | \$ 80,000 |
| Billed by Working Capital Fund | 0 | \$ 39,000 |

4. City taxes receivable, per tax roll, amounted to $\$ 10,000,000$.
5. All unpaid city taxes become delinquent at the end of the year in which levied.
6. Unrecorded amounts at the close of the fiscal year consisted of

| Accrued salaries | \$60,000 |  |
| :---: | :---: | :---: |
| Invoices for materials and supplies received | 19,000 | \$79,000 |
| Orders placed by the City but not fill |  | 30,000 |

7. Services billed by the Working Capital Fund, not recorded on the books of General Fund, amounted to $\$ 1,000$.
8. The General Fund stores inventory amounted to $\$ 35,000$ at end of period and is to be recorded. The City's charter provides that expenditures are based on purchases.
9. The City's charter specifies that purchase orders unfilled at the end of the year do not lapse.

## Required:

Prepare a worksheet for the General Fund with columns for "Balances per Books," "Corrections and Adjustments" and "Corrected Balances." Key the corrections and adjustments to the related transaction numbers. Formal general journal entries are not required.

## EXAMINATION IN AUDITING

## November 9, 1961; 8:30 a.m. to $12: 00 \mathrm{~m}$. <br> (All questions are required.)

## Number 1 (Estimated time- 20 to 25 minutes)

a. A client, without consulting its CPA, has changed its accounting so that it is not in accordance with generally accepted accounting principles. During the regular audit engagement the CPA discovers that the statements based on the accounts are so grossly misleading that they might be considered fraudulent.

1. Discuss the specific action to be taken by the CPA.
2. In this situation what obligation does the CPA have to outsiders if he is replaced? Discuss briefly.
3. In this situation what obligation does the CPA have to a new auditor if he is replaced? Discuss briefly.
b. The client of a CPA is a partnership. The drawings of the managing partner are considerably in excess of his pro rata share of earnings. Other partners are not aware of his excess drawings because financial statements and tax returns are submitted to them without details of individual partner balances or withdrawals. No salaries are paid to the partners.
4. Discuss the specific action to be taken by the CPA.
5. In this situation what obligation does the CPA have to the other partners? Discuss briefly.
6. In this situation what obligation does the CPA have to outsiders? Discuss briefly.
7. What agreements might be found in the contract between the partners to make unnecessary any action by the CPA?

## Number 2 (Estimated time-15 to 20 minutes)

XYZ Corporation has several hundred employee travel advances outstanding at all times. Subsidiary ledger cards for individual employees are controlled by a general ledger account. Certain advances are specifically designated "permanent"; all others are intended to be cleared at the end of each field trip. All cash transactions, i.e., advances, reimbursements, or returns, and all expenses reported are posted to the subsidiary ledger cards.

## Required:

Assuming no restrictions have been placed on the scope of your audit, prepare an audit program for the examination of the outstanding travel advances and the general ledger control account.

## Number 3 (Estimated time- 20 to 25 minutes)

You are engaged in auditing the financial statements of Henry Brown, a large independent contractor. All employees are paid in cash because Mr. Brown believes this arrangement reduces clerical expenses and is preferred by his employees.

During the audit you find in the petty cash fund approximately $\$ 200$ of which $\$ 185$ is stated to be unclaimed wages. Further investigation reveals that Mr. Brown has installed the procedure of putting any unclaimed wages in the petty cash fund so that the cash can be used for disbursements. When the claimant to the wages appears, he is paid from the petty cash fund. Mr. Brown contends that this procedure reduces the number of checks drawn to replenish the petty cash fund and centers the responsibility for all cash on hand in one person inasmuch as the petty cash custodian distributes the pay envelopes.

## Required:

a. Does Mr. Brown's system provide proper internal control of unclaimed wages? Explain fully.
b. Because Mr. Brown insists on paying salaries in cash, what procedures would you recommend to provide better internal control over unclaimed wages?

## Number 4 (Estimated time 25 to 30 minutes)

You are the senior accountant in the audit of the Paulsen Grain Corp. whose business primarily involves the purchase, storage and sale of grain products. The corporation owns several elevators located along navigable water routes and transports its grain by barge and rail. Your assistant submitted the following analysis for your review.

## Paulsen Grain Corporation <br> ADVANCES PAID ON BARGES UNDER CONSTRUCTION-a/c 210 December 31, 1960

Advances Made:
1/15/60-Ck. \#3463-Jones Barge Construction Co. \$100,000(1)
4/13/60-Ck. \#4129-Jones Barge Construction Co. 25,000(1)

6/19/60-Ck. \#5396-Jones Barge Construction Co.
Total payments
Deduct cash received 9/1/60 from Eastern Life Insurance Co.
Balance per general ledger- $12 / 31 / 60$
63,000(1)
$\$ 188,000$
(1) Examined approved check request and cancelled check and traced to cash disbursements record.
(2) Traced to cash receipts book and to duplicate deposit ticket.

## Required:

a. In what respects is the analysis incomplete for report purposes? (Do not include any discussion of specific auditing procedures.)
b. What two different types of contractual arrangements may be inferred from your assistant's analysis?
c. What additional auditing procedures would you suggest that your assistant perform before you accept the working paper as being complete?

## Number 5 (Estimated time-25 to 30 minutes)

Client Corporation (whose fiscal year will end December 31, 1960) informs you on December 18, 1960 that it has a serious shortage of working capital because of heavy operating losses incurred since October 1, 1960. Application has been made to a bank for a loan, and the bank's loan officer has requested financial statements.

## Required:

Indicate the type of opinion you would render under each of the following independent sets of circumstances. Give the reasons for your decision.
a. Client Corporation asks that you save time by auditing the financial statements prepared by Client's chief accountant as of September 30, 1960. The scope of your audit would not be limited by Client in any way.
b. Client Corporation asks that you conduct an audit as of December 15, 1960. The scope of your audit would not be limited by Client in any way.
c. Client Corporation asks that you conduct an audit as of December 31, 1960 and render a report by January 16 . To save time and reduce the cost of the audit it is requested that your examination not include circularization of accounts receivable or observation of the taking of inventory.
d. Client Corporation asks that you prepare financial statements as of December 15, 1960 from the books and records of the company without audit. The statements are to be submitted on plain paper without your name being associated in any way with them. The reason for your preparing the statements is your familiarity with proper form for financial statements.

## Number 6 (Estimated time- $\mathbf{2 5}$ to 35 minutes)

Compare the confirmation of accounts receivable with the confirmation of accounts payable under the following headings:
a. Generally accepted auditing procedures. (Justify the differences revealed by your comparison.)
b. Form of confirmation requests. (You need not supply examples.)
c. Selection of accounts to be confirmed.

## Number 7 (Estimated time- $\mathbf{3 5}$ to 45 minutes)

A new client, Carr Corporation, requested you to review the account titled "Insurance." Carr Corporation commenced business on January 1, 1959 and wants
to correct the financial statements for 1959 and 1960. They were prepared by the bookkeeper who failed to take cognizance of any adjustments in the account. There were appropriate business reasons for the variance in inception dates for various policies. Data from examination of the account and insurance policies follow:

## INSURANCE

Debits: 1959

| January 3 | Annual premium of insurance policy on life of officer. Date |
| :---: | :---: |
|  | of policy is January 1, 1959 |

January $20 \quad \begin{gathered}\text { Deposit on workmen's compensation insurance premium for } \\ \text { 1959. Coverage is from January } 1 \text { to December } 31 \ldots\end{gathered} \quad 1,900$
July $15 \quad \begin{gathered}\text { Premium on fire insurance on building and contents covering } \\ \text { period from August 1, } 1959 \text { to July 31, } 1962 \ldots . . .\end{gathered} \quad 3,600$
$\begin{array}{cc}\text { September } 15 & \begin{array}{c}\text { Premium on employees' fidelity bonds covering period from } \\ \text { September 1, } 1959 \text { to August 31, } 1960 \ldots . . . . . . . . . . . . . . . . . . . . ~\end{array}, 000\end{array}$
October $30 \quad \begin{gathered}\text { Cash shortage of employee to be reimbursed by insurance } \\ \text { company } \ldots \ldots . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . ~ \\ 500\end{gathered}$
Credits: 1959

December 31 To profit and loss . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 13,460
Debits: 1960
January 3 Annual premium of insurance policy on life of officer ... $\$ \mathbf{6 , 0 0 0}$

$\begin{array}{ll}\text { January } 17 \quad \begin{array}{c}\text { Premium on fire insurance on addition to existing building } \\ \text { during construction period, January } 15 \text { to May } 15,1960 .\end{array} & 500\end{array}$


May $10 \quad \begin{gathered}\text { Additional premium on fire insurance policy covering building } \\ \text { addition from May } 15,1960 \text { to July } 31,1962 \ldots . . . .\end{gathered} \quad \mathbf{2 , 6 5 0}$

September $15 \begin{gathered}\text { Premium on employees' fidelity bonds covering period from } \\ \text { September } 1,1960 \text { to August } 31,1961 \ldots . . . . . . . . . . . . . . . . . . . . . . . ~\end{gathered}$ 1,800


Credits: 1960
March 1 Payment of cash shortage by insurance company .......... \$ 500

December 31 To profit and loss . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 15,500
$\$ 17,700$

1. On December 31, 1960 the premium on automobile insurance had not been paid or recorded. The insurance agent reported there would be no change in the premium.
2. The cash surrender value of the insurance policy on the life of the officer amounted to $\$ 1,200$ on December 31, 1960 and was not recorded. On December 9,1960 the client, in accordance with its election, received a cash dividend of $\$ 360$ on the life insurance policy which was credited to miscellaneous income.
3. The actual workmen's compensation premium for 1960 was determined to be $\mathbf{\$ 1 , 9 0 0}$.

## Required:

a. Prepare a worksheet which will properly identify and distribute all amounts related to insurance for 1959 and 1960.
b. Prepare the worksheet entry to correct the financial statements for 1959.
c. Prepare the worksheet entry to correct the financial statements for 1960.

## EXAMINATION IN COMMERCIAL LAW

November 10, 1961; 8:30 a.m. to 12:00 m.
(All questions are required.)

## Number 1 (Eatimated time- 15 to 25 minutes)

You are to select all of those phrases which state a correct legal conclusion based on general principles of insurance law. Indicate your selection by placing an "X" in the appropriate column on an answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select correct answers will be penalized.

1. The Statute of Frauds requires that:
a. All types of insurance contracts be in writing to be enforceable.
b. Life insurance contracts be in writing to be enforceable, but property insurance contracts need not be in writing.
c. Property insurance contracts, with the exception of automobile liability coverage, be in writing to be enforceable.
d. Insurance contracts with a face value in excess of $\$ 500$ be in writing to to be enforceable.
e. None of the above is correct.
2. Property insurance is basically a:
a. Form or type of investment.
b. Contract of indemnity.
c. Wager and thus an exception to the gambling laws.
d. Risk spreading device which distributes the loss over a group of persons.
e. None of the above is correct.
3. Property insurance normally protects the policy holder against:
a. His own negligence.
b. His own intentional and willful destruction of the subject matter.
c. The intentional and willful destruction of the property by a third person.
d. The negligent destruction of the property by a third person.
e. None of the above is correct.
4. The beneficiary of a life insurance policy (which he did not purchase):
a. Must have given some consideration to the insurer in order to enforce his rights.
b. Has a vested interest in the policy unless the policy reserves for the insured the right to change the beneficiary.
c. Is normally a third party donee beneficiary.
d. Is normally an incidental beneficiary.
e. None of the above is correct.
5. A corporation has an insurable interest in:
a. Its buildings and other real property.
b. The lives of its key executives.
c. The property which has been pledged with it in order to secure the repayment of loans by its debtors.
d. The lives of debtors to whom it has loaned money on general credit.
e. Property sold to customers but which it holds as a bailee.
6. An insurable interest must exist:
a. In order to prevent wagering on the lives and property of others.
b. At least at the time of destruction in the case of property insurance.
c. At the time of the taking out of the policy in the case of life insurance.
d. At the time of death in the case of life insurance.
e. None of the above is correct.
7. The following people could validly insure the life of an individual:
a. His divorced wife who has remarried.
b. His minor children.
c. His fellow partners.
d. His general creditors.
e. His doctor.
8. The following people could validly take out property insurance on a piece of property:
a. An unpaid creditor who sold the property under a conditional sales contract.
b. A stockholder of the corporation which owns the property.
c. A mortgagor who has mortgaged the property.
d. A remainderman who will take the property upon the death of the life tenant.
e. A general creditor of the debtor who owns the property, if this is the debtor's most valuable asset.
9. It is generally provided that:
a. Life insurance policies are freely assignable.
b. Property insurance policies are freely assignable.
c. Property insurance policies are only assignable after destruction of the property.
d. Notification of assignment of life insurance policies must be given to the insurer.
e. None of the above is correct.
10. If the period provided for in the incontestable clause of a life insurance policy has elapsed, the insurer will be precluded from asserting the defense of:
a. Misstatement of fact.
b. Lack of insurable interest.
c. Nonpayment of premiums.
d. Nondisclosure of a material fact.
e. None of the above is correct.
11. In the event of a total destruction of the property insured under an open or unvalued fire insurance policy:
a. The insured will receive the full value of the loss provided the face amount of the policy is greater than the loss.
b. The insured will receive the face value of the policy even though the loss exceeds the face value.
c. The insured will receive the face value of the policy even though the loss is less than that amount.
d. The insurer may provide in the policy for the option to reconstruct in lieu of a payment in cash.
e. None of the above is correct.
12. The right of subrogation may arise under:
a. Life insurance policies.
b. Fire insurance policies.
c. Marine insurance policies.
d. Automobile collision insurance policies.
e. None of the above is correct.
13. The creditors of the insured:
a. May compel the insured to surrender the policy for the cash surrender value even though the insured has not reserved the right to change the beneficiary.
b. May recover from the insured's estate if the proceeds of the policy were payable to the insured or his estate upon his death.
c. Have a right to the proceeds, to the extent of the premiums paid, even though the insured or his estate is not the beneficiary, if the premiums were paid in fraud of creditors.
d. Have no rights to the insurance proceeds under any circumstances.
e. None of the above is correct.
14. The coinsurance clause in insurance policies:
a. Is implied as a matter of law in marine insurance contracts.
b. Must be expressly stated in fire insurance policies.
c. Is not applicable to total losses.
d. Limits the recovery for partial losses unless the insured insures up to the specified percentage of the fair market value of the property.
e. None of the above is correct.
15. A fire insurance policy covering mortgaged property:
a. May be taken out by the mortgagor (or mortgagee) solely for his own benefit.
b. Will continue to cover the property even after it has been sold, provided the mortgagor intends to sell the insurance policy as well as the property.
c. May be taken out by the mortgagor for the benefit of the mortgagee as well as for his own benefit.
d. Gives the insurance company the right of subrogation even if taken out by the mortgagee solely for his own benefit.
e. None of the above is correct.

## Number 2 (Estimated time- 15 to 25 minutes)

You are to select all of those phrases which state a correct legal conclusion based on general principles of the law of bailments and personal and real property. Indicate your selection by placing an " X " in the appropriate column provided on the answer sheet. Note that some of the questions may contain more than one correct statement. Select every correct answer because credit will be given for every correct selection; incorrect answers or failure to select correct answers will be penalized.

1. In a bailment:
a. The bailee has title and possession.
b. The bailor relinquishes title.
c. The bailor retains possession.
d. The bailee has possession but lacks title.
e. None of the above is correct.
2. In a bailment, risk of loss due to accidental nonnegligent destruction of the property:
a. Is determined in accordance with the Statute of Frauds.
b. Will be the same whether or not the transaction is a bailment or a sale.
c. Falls upon the party having possession.
d. Falls upon the bailor in that he has title.
e. Is shared equally by the parties.
3. The following are examples of bailments:
a. Parking a car in a parking lot and retaining the keys.
b. Leaving a watch at a repair shop to be repaired.
c. Finding lost property and retaining same for the owner.
d. Retaining goods which have been sold but are to be picked up later by the buyer.
e. Margin trading on the Stock Exchange.
4. The following elements are necessary to constitute a pledge:
a. Possession by the pledgor.
b. Property used to secure a loan or other obligation.
c. Either real or personal property.
d. A right of redemption retained by the pledgor.
e. Title retained by the pledgor.
5. Although the bailee is normally not an insurer of property, the following bailees are exceptions to this rule:
a. Innkeepers.
b. Common carriers.
c. Private carriers.
d. Warehousemen.
e. None of the above.
6. In a bailment for hire or use of property (e.g., renting a car from a rent-a-car system):
a. The bailor implicitly warrants that the property will be fit for the purpose of the bailment.
b. The bailor must inspect the property and remedy the detectable defects.
c. The bailee is an insurer of the property if he uses it outside the scope of the bailment contract.
d. The bailee must exercise reasonable care in the use of the property.
e. Either the bailee or bailor can properly maintain an action against a third party who has converted the property.
7. Effective transfer of possession in a bailment can be accomplished by:
a. Actual delivery of the property itself to the bailee.
b. An agreement by the bailee to hold the property for the bailor.
c. Delivery to the bailee of the key to the place where the goods are stored.
d. A binding contract to deliver the property at a future date.
e. Delivery to the bailee of a negotiable document of title which represents the actual property.
8. The following rights and duties of the bailee are the same regardless of the type of bailment:
a. The duty to exercise great care.
b. The duty to return the property in a safe and sound condition.
c. The right to use the property.
d. The right to prevent outsiders from taking the property.
e. The right to reimbursement for expenses.
9. The following are examples of mutual benefit bailments:
a. A pledge.
b. Leaving a string of pearls to be restrung.
c. Checking a parcel for ten cents.
d. Hanging one's coat on a coat rack in a restaurant.
e. Picking up and retaining lost property.
10. An innkeeper will not be liable to his guest for property left in the inn if the property was lost or destroyed as a result of:
a. A trusted employee's theft of the property.
b. A fire which was started by the negligence of a person who came to eat at the inn.
c. An earthquake.
d. The guest's own negligence.
e. An armed robbery.
11. In order for a gift causa mortis to be valid:
a. There must be an actual or constructive delivery of the subject matter of the gift.
b. There must be an intent to pass present title to the property.
c. The gift must be made in fear or in contemplation of death.
d. The donor must die from the cause which induced him to contemplate the gift.
e. The donee must not predecease the donor.
12. Which of the following items are personal property?
a. Trees which have been cut into logs and stacked on the owner's land awaiting use thereon.
b. A mortgage on land and buildings.
c. A promissory note received in connection with the sale of land.
d. A stone wall built around a homeowner's country estate.
e. An interest in a real estate partnership.
13. Which of the following are real property?
a. Shares of stock in a corporation which has a large ranch as its principal asset.
b. A grove of fruit trees.
c. Mineral deposits.
d. A trade fixture.
e. An insurance policy on a homeowner's country villa.
14. The requisites for conversion of personal property to real property are:
a. Actual annexation to the realty.
b. The consent of both landlord and tenant.
c. An intent to make the personal property a permanent addition to the realty.
d. The use of the personal property with the purpose of materially benefiting the real property.
e. None of the above is correct.
15. In order to establish title to real property by adverse possession, the party so claiming must, among other things:
a. Have originally been on the land with the consent of the owner.
b. Record his claim.
c. Be acting in good faith.
d. Have had a continuous possession for the period prescribed by the statute of limitations.
e. None of the above is correct.

## Number 3 (Estimated time- 15 to 25 minutes)

a. Tom, Jerry, Neil and Jay decided to form a limited partnership for the purpose of operating a farm. They selected the limited partnership as the form of business entity most suitable for their purpose. Jerry was to serve as the general partner and contribute $\$ 5,000$ in capital. Tom, Neil and Jay were to contribute $\$ 10,000$ each and were to be limited partners. All the above mentioned capital contributions were made and the necessary limited partnership papers were duly filled out and properly filed in the appropriate state office designated for such purpose. The partnership agreement and the papers filed clearly in-
dicated that Jerry was the sole general partner. The others were to be treated as limited partners and liable only to the extent of their capital contributions.

Jerry managed the partnership during the first two years. However, during the third year Tom and Neil overruled Jerry as to the type of crops to be planted, exercised the power to draw checks on the firm account and finally replaced Jerry with a new and more receptive general partner. Jay did not join his fellow partners in these activities. However, his name was used, with his knowledge and consent, on the partnership stationery as part of the firm name. Some of the creditors knew that Jay was only a limited partner.

1. Are Tom and Neil personally liable for any of the partnership debts? If so, to what extent? Explain.
2. Is Jay personally liable on any of the partnership debts? If so, to what extent? Explain.
b. What is the order of priority of payment of limited partnership obligations in settling accounts upon dissolution?

## Number 4 (Estimated time- $\mathbf{1 5}$ to 25 minutes)

a. On January 2, 1961 Richard Retailer purchased twenty television sets on credit, executing trust receipts which stated that title remained in the finance company to secure payment of the price. The Uniform Trust Receipts Act was in force and it required the filing of a statement that trust receipt financing was contemplated. That provision of the Act was complied with on January 3, 1961. On August 15, 1961 Richard Retailer became bankrupt and the finance company claimed the remaining television sets on hand. The trustee in bankruptcy also claimed the television sets and claimed that the finance company had a "voidable preference."

1. What is meant by the term "preference" under the Bankruptcy Act? Explain.
2. Who will prevail in the above case, the finance company or the trustee? Explain.
3. Suppose, instead of selling on credit via trust receipts financing, the manufacturer had sold the twenty sets for fair market value to Richard Retailer one week before bankruptcy. Could this transaction be set aside as a preference? Explain.
b. List and explain four acts of bankruptcy.

## Number 5 (Estimated time- 15 to 25 minutes)

a. Harry, a homeowner, engaged a construction contractor to design and build a barbecue pit and several benches and tables. The price was not fixed in the contract, but it was agreed that it would not exceed $\$ 600$. After completion of the work, the contractor sent Harry a bill for $\$ 598$. Harry in reply sent a check for $\$ 400$ with these words written on the back above the space where
the indorsement normally is written: "Payment in full for construction of barbecue pit and benches and tables." In addition, Harry wrote an accompanying letter in which he stated: "I enclose a check for $\$ 400$ for the work you did for me in connection with my barbecue pit and the benches and tables. Your price was far in excess of the value of the work performed and I send you this check (please note the statement on the back) in full satisfaction of your claim. Take it or leave it." The contractor immediately informed Harry that he would not accept this amount in full satisfaction but would credit it to Harry's account. The contactor then struck out the language on the back, indorsed it and cashed it at his bank.

1. What is the method of discharge that Harry will undoubtedly claim as a result of contractor's cashing the check? Explain.
2. Is Harry's debt entirely discharged? Explain.
b. James borrowed $\$ 100$ from George at $5 \%$ interest and gave George a promissory note for $\$ 105$ payable one year from the date of the loan. The year having elapsed, James tendered a check for $\$ 90$ with these words marked on the back above the space where George would indorse it: "I (George) hereby accept the face amount of this check in complete satisfaction of the debt owed by James." George cashed the check and now seeks to recover the balance from James. Is the entire debt discharged? Explain.

## Number 6 (Estimated time- $\mathbf{1 5}$ to 25 minutes)

Able, Baker and Charlie were directors of the ABC Corporation. During the early years the corporation met with moderate success and showed a small annual profit each year. There was nothing in the corporate charter or by-laws in respect to compensation for directors and during this initial period the directors did not seek or receive any compensation. In 1960 the corporation had a banner year, several new contracts were obtained, and a new product line that the directors decided the corporation should make and sell proved highly profitable. The directors performed the usual and customary services and duties of their office in a highly competent and skillful manner and their efforts were to a large extent responsible for the large profit obtained in 1960. After the 1960 income statement was received and examined by the directors, they met on March 15, 1961 and voted themselves a retroactive bonus of $\$ 10,000$ each as the reasonable value of services for the past years. Sherman, a stockholder of record, objected to this action and now brings a derivative stockholder's action against the directors and seeks to obtain a judgment against each of the directors to the extent of the bonus he received.

## Required:

a. What is meant by the term "derivative stockholder's action"? Explain.
b. Are the directors entitled to retain the bonuses received by them? Explain.
c. In the event that a stockholder is successful in a derivative action, what happens to the money received as a judgment against the directors? Explain.

## Number 7 (Estimated time-20 to $\mathbf{3 0}$ minutes)

a. Thomas transferred his transistor manufacturing business to the $\mathbf{X}$ Trust Company in trust for the benefit of his son, Peter, for life, with the remainder to go to Peter's son James. The $\mathbf{X}$ Trust Company insured the business with the $\mathbf{Y}$ Insurance Company by taking out two policies. The first policy was a standard fire insurance policy covering the building, equipment, etc. The other policy was secured to cover the loss of income during any period that the business was inoperable as a result of tornado, earthquake or fire. The buildings and equipment were subsequently destroyed by fire and the Y Insurance Company paid the proceeds to the X Trust Company. Both Peter and James claim the entire proceeds of the insurance policies. What disposition should the X Trust Company make of the entire proceeds under the terms of the trust? Explain.
b. In December 1958 Howard transferred 1,000 shares of Z Company stock to the X Trust Company in trust for the benefit of his wife for life with the remainder to go to his son. The Z Company declared a noncash dividend in 1960 of 10 shares of stock of the M Company for each 100 shares of $Z$ Company stock. The M Company stock had been bought by Z Company as an investment. The son claims that this dividend should be added to the corpus (principal) whereas the wife claims that she is entitled to the dividend. How should the trust company treat the dividend? Explain.
c. Same facts as above except that in 1960 the Z Company split-up its stock 2 -for1. Subsequently, the trustee sold one half of the 2,000 shares of the $\mathrm{Z} \mathrm{Com}-$ pany stock at a profit and the son and wife both claim the proceeds. How should the trust company treat the stock split-up and the proceeds from the sale? Explain.
d. $X$, as trustee for the benefit of $Y$, the life beneficiary, received the $\$ 1,000$ annual cash dividends on the stock which made up the corpus of the trust. $Y$ was abroad at the time of receipt and $X$ in good faith and with complete honesty deposited the money in his own (X's) bank account. Before Y returned X's bank failed and the dividend in bankruptcy will only amount to fifty cents on the dollar. $Y$ claims that $X$ must make up the difference. Is $X$ liable? Explain.

## Number 8 (Estimated time-20 to $\mathbf{3 0}$ minutes)

a. What is the legal relationship of an accountant to his client? Explain.
b. What is the legal duty of skill and care that the accountant-client relationship imposes upon the accountant? Explain.
c. Compare the accountant's common law liability to clients and third parties for actual fraud committed by the accountant with his liability to them for ordinary negligence. Explain.
d. In addition to the civil liability imposed upon the accountant, certain federal statutes impose criminal liability on those preparing financial statements. List three well-known statutes which have so imposed liability and with which accountants are frequently concerned.
e. 1. What is meant by privileged communication? Explain.
2. Does the common law recognize the existence of a privilege insofar as the accountant-client relationship is concerned? Explain.
3. Assuming that the accountant-client relationship is privileged, who has the right to waive the privilege? Explain.

# EXAMINATION IN THEORY OF ACCOUNTS 

## November 10, 1961; 1:30 to 5:00 p.m. <br> (All questions are required.)

## Number 1 (Estimated time- 15 to 20 minutes)

You have been asked to assist the chief accountant of the Chenault Corporation in the preparation of a balance sheet. The outline presented below represents the various classifications suggested by the chief accountant for the balance sheet; classification " O " has been added for items to be excluded from the balance sheet.

## Assets

A. Current
B. Investments
C. Plant and equipment
D. Intangibles
E. Deferred charges
F. Other assets

Liabilities and Capital
G. Current
H. Long-term
I. Other liabilities
J. Preferred stock
K. Common stock
L. Contributions in excess of par or stated value
M. Retained earnings
N. Other capital
O. Items excluded from the balance sheet.

## Required:

Number a sheet of Form G down the left margin from 1 to 25.
Using the Form G and the letters above, classify the following accounts according to the preferred balance sheet presentation. If the account is an offsetting or valuation account, mark an " $X$ " before the letter. For example, "Allowance for Doubtful Accounts" would be "X-A."

1. Dividend payable (on Chenault's preferred stock).
2. Plant construction in progress.
3. Factory building (retired from use and held for sale).
4. Reserve for higher plant replacement costs.
5. Land (held for possible future building site).
6. Merchandise inventory (held by Chenault Corporation on consignment).
7. Stock dividend payable (in common stock to common stockholders and to be issued at par).
8. Office supplies inventory.
9. Sinking fund cash (First National Bank, Trustee).
10. Reserve for retirement of preferred stock.
11. Installment sales accounts receivable (average collection period eighteen months).
12. Reserve for possible decline in inventory value.
13. Advances to officers (indefinite repayment date).
14. Unredeemed merchandise coupons.
15. Reserve for self-insurance.
16. Inventory of small tools.
17. Unissued common stock.
18. Liability for loss on merchandise purchase commitments.
19. Reserve to reduce inventory to market.
20. Matured capital stock subscriptions (called by the board of directors and considered collectible).
21. Common stock subscribed (Chenault Corporation's stock).
22. Reserve for sinking fund.
23. Securities held as collateral.
24. Bank overdraft.
25. Contracts payable, retained percentage.

## Number 2 (Estimated time- 10 to 15 minutes)

Many business enterprises have a natural business year. The natural business year varies according to the type and nature of the enterprise and frequently does not coincide with the calendar year.

## Required:

a. Define "natural business year."
b. Discuss briefly the reasons for changing the accounting period of a company to a "natural business year."

## Number 3 (Estimated time- 25 to 35 minutes)

To keep funds free for working capital purposes, many companies prefer to rent facilities under a long-term lease with a renewal option rather than purchase them. In such cases it has been suggested that the value of the leasehold be displayed as an asset in the tenant's balance sheet and that a liability be established for the obligation incurred.

## Required:

a. List and discuss briefly the arguments for and against recording the leasehold and the liability on the tenant's books.
b. Under what circumstances might a leasehold or liability related thereto require recognition on the tenant's books?

## Number 4 (Estimated time- 25 to 30 minutes)

Bond indentures which require the borrower to accumulate a sinking fund may also require the borrower to create a reserve for sinking fund for the protection of creditors.

## Required:

a. How does the creation of a reserve for sinking fund contribute to the protection of creditors?
b. List five other provisions which could be included in a bond indenture for the protection of the creditors. Indicate how each accomplishes its purpose.

## Number 5 (Estimated time- 25 to 35 minutes)

On January 2, 1960 the stockholders of the Transithon Company authorized a stock option plan which provided for the granting to key employees of options to purchase an aggregate of 20,000 shares of $\$ 10$ par value common stock of the corporation at $\$ 14$ per share. The market value of the stock was $\$ 16$ on this date.

The next day, January 3, 1960, options to purchase 3,000 shares were granted to the president: 1,000 shares for services rendered in 1959; 1,000 shares for services to be rendered in 1960; and 1,000 shares for services to be rendered in 1961. The options are exercisable during the six months following the year in which the services were rendered. The market value of the stock was $\$ 17$ on January 3,1960 .

The president exercised his option for 1,000 shares on April 1, 1960 when the market price was $\$ 20$ per share. Subsequently he sold the stock on September 1, 1960 at $\$ 18$ per share.

The president did not exercise his option in 1961. When the option lapsed on June 30, 1961 the market value of the stock was $\$ 12$ per share.

## Required:

a. Give the journal entry or entries required in 1960 under the plan, and to record lapsing of the option in 1961 (if necessary).
b. Explain fully the reasons or principles underlying the entries.

## Number 6 (Estimated time- $\mathbf{3 0}$ to $\mathbf{4 0}$ minutes)

Information concerning the operations of a corporation may be presented in an income statement or in a combined "statement of income and retained earnings." Income statements may be prepared on a "current operating performance" basis ("earning power concept") or an "all-inclusive" basis ("historical concept"). Proponents of the two types of income statements do not agree upon the proper treatment of material extraordinary charges and credits.

## Required:

a. Define "current opeating performance" and "all-inclusive" as used above.
b. Explain the differences in content and organization of a "current operating performance" income statement and an "all-inclusive" income statement. Include a discussion of the proper treatment of material extraordinary charges and credits.
c. Give the principal arguments for the use of each of the three statements, "allinclusive" income statement, "current operating performance" income statement and combined "statement of income and retained earnings."

## Number 7 (Estimated time-25 to 35 minutes)

Many companies report taxable income which is different from their accounting income because generally accepted accounting principles are not always appropriate for determination of taxable income. When such differences occur, they raise a question as to whether the income tax amount shown in the income statement should be (1) the amount of taxes actually payable for the period or (2) the amount which is allocable to (that is, the amount which would be payable on) the income reported in the income statement.

## Required:

a. Briefly discuss income tax allocation. Include in your discussion a definition of the term and the arguments for allocation.
b. List six arguments which have been advanced against income tax allocation.

# EXAMINATION IN ACCOUNTING PRACTICE—PART I 

May 16, 1962; 1:30 to 6:00 p.m.

## (All problems are required.)

## Number 1 (Estimated time- $\mathbf{3 0}$ to 45 minutes)

Mark on your answer sheet the correct letter for each of the following items. The answers should be selected in accordance with the current Internal Revenue Code and Regulations. There is only one correct answer for each question.

1. John Green, single, reported an adjusted gross income of $\$ 8,000$ for 1961. During 1961 he made the following contributions: Harris University, \$500; American Red Cross, $\$ 1,000$; Boy Scouts, $\$ 600$; and Girl Scouts, $\$ 400$. Green's maximum charitable deduction is:
a. $\$ 2,500$.
b. $\$ 2,400$.
c. $\$ 2,100$.
d. $\$ 1,600$.
e. None of the above.
2. An individual pays the following taxes which are not incurred in connection with a trade or business during 1961: state gasoline, \$40; federal gasoline, $\$ 70$; real estate, $\$ 500$; personal property, $\$ 100$; federal excise, $\$ 50$; state sales, $\$ 150$; state stock transfer on sale of securities, $\$ 60$; and state income, $\$ 90$. His deduction for all taxes for 1961 would be:
a. $\$ 1,060$.
b. $\$ 1,010$.
c. $\$ 990$.
d. $\$ 940$.
e. None of the above.
3. In 1954 Father purchased 1,000 shares of $\mathbf{Z}$ Company stock for $\$ 10,000$. In 1961, when the stock had a fair market value of $\$ 9,000$, Father gave it to Son and paid a gift tax of $\$ 2,000$ thereon. The basis of the stock to Son for determining gain would be:
a. $\$ 7,000$.
b. $\$ 9,000$.
c. $\$ 10,000$.
d. $\$ 11,000$.
e. None of the above.
4. Assume the same facts as in 3 ; the basis of the stock to Son for determining loss would be:
a. $\$ 7,000$.
b. $\$ 9,000$.
c. $\$ 10,000$.
d. $\$ 11,000$.
e. None of the above.
5. Husband and wife, both over 65 and disabled, filed a joint return for 1961. Husband's total medical expenses for the year were $\$ 22,000$ and wife's were $\$ 12,000$. The maximum deduction would be:
a. $\$ 20,000$.
b. $\$ 27,000$.
c. $\$ 30,000$.
d. $\$ 34,000$.
e. None of the above.
6. A corporation with a capital loss in excess of capital gains for 1961 would exhaust the capital loss by applying it to capital gains in other taxable years in the following sequence:
a. $1960,1959,1958,1962,1963,1964,1965,1966$.
b. 1958, 1959, 1960, 1962, 1963, 1964, 1965, 1966.
c. $1960,1959,1958,1957,1956,1962,1963,1964$.
d. 1956, 1957, 1958, 1959, 1960, 1962, 1963, 1964.
e. None of the above.
7. The Limestone Mining Company had gross mining income of $\$ 200,000$. Its net taxable mining income before depletion was $\$ 10,000$. The regular percentage depletion rate on limestone is $15 \%$. Cost depletion is $\$ 2,000$. The company is entitled to a depletion deduction of:
a. $\$ 1,200$.
b. $\$ 1,500$.
c. $\$ 2,000$.
d. $\$ 5,000$.
e. None of the above.
8. A, who is single, supports his 70 -year-old father. During the year A paid doctors' fees of $\$ 1,250$ in connection with an illness of his father. A's adjusted gross income for the year was $\$ 10,000$. A is entitled to a medical expense deduction of:
a. Zero.
b. $\$ 950$.
c. $\$ 1,150$.
d. $\$ 1,250$.
e. None of the above.
9. In 1961 a farmer sells for $\$ 10,000$ five acres of land which had 500 bushels of grain standing on it at the time of sale. The land cost $\$ 5,000$ in 1941 and his expenses of planting and raising the grain were $\$ 250$. The fair market value of the standing grain was $\$ 1.00$ per bushel. His capital gain would be:
a. $\$ 4,500$.
b. $\$ 4,750$.
c. $\$ 5,000$.
d. $\$ 5,500$.
e. None of the above.
10. Bartschat Corporation sold 100 shares of its $\$ 5.00$ par common stock for $\$ 5,000$. The stock had been originally issued for $\$ 30$ per share and was reacquired for $\$ 25$ per share. The corporation has a capital gain of:
a. $\$ 2,000$.
b. $\$ 2,500$.
c. $\$ 3,000$.
d. $\$ 4,500$.
e. None of the above.
11. A corporation's first tax return can not use the following method of valuing inventory:
a. Last in, first out.
b. First in, first out.
c. Base stock.
d. Standard cost.
e. None of the above.
12. In April 1961 Green received a gift of a corporate bond which cost the donor $\$ 1,000$ and had a fair market value of $\$ 800$ at the date of gift. Green sold the bond for $\$ 900$ in July 1961. The transaction results in:
a. No recognized gain, loss or income.
b. Ordinary income of $\$ 100$.
c. A capital gain of $\$ 100$.
d. A capital loss of $\$ 100$.
e. None of the above.
13. Blue purchased 100 shares of Gemo Corporation stock for $\$ 3,000$ on January 16, 1961 and sold the stock on April 15, 1961 for $\$ 2,800$. He purchased another 100 shares on May 1, 1961 for $\$ 2,900$ and sold the stock on August 1, 1961 for $\$ 2,600$. The transaction on August 1 results in:
a. Short-term loss of $\$ 300$.
b. Short-term loss of $\$ 400$.
c. Long-term loss of $\$ 400$.
d. Long-term loss of $\$ 500$.
e. None of the above.
14. Retirement income of a taxpayer over 65 , for the purpose of computing the retirement income credit, would exclude:
a. Interest on corporation bonds.
b. Rents from an apartment house.
c. Dividends on stock of a foreign corporation.
d. Interest on municipal bonds.
e. None of the above.
15. A taxpayer and his wife are not permitted to file a joint return for 1961 if:
a. They are living separately on December 31, 1961.
b. The wife is a nonresident alien.
c. The wife has no gross income.
d. The entire support of the wife is provided by her father.
e. None of the above.

Mark your answer sheet indicating whether or not each of the following
statements is true or false. Your grade on the true-false questions will be determined by deducting your total of incorrect answers from your total of correct answers; if you omit an answer it will not affect either total.
16. A nonbusiness bad debt is treated as if it were a short-term capital loss regardless of the period of time that the receivable had been owned.
17. Mr. A has a capital loss carryover from the year 1960 of $\$ 2,500$. His taxable income for 1961 is $\$ 500$ before deducting his personal exemptions. He had no capital gains or losses during 1961. His capital loss carryover to 1962 is $\$ 2,000$.
18. Mr. A, a dentist, sold 10 shares of X Corporation stock for $\$ 800$ to Mr. B who has agreed to pay in four equal annual installments. Mr. A may elect to report his gain or loss on the transaction under the installment method.
19. All state and local taxes are deductible for federal income tax purposes.
20. Subject to the usual limitation, transportation expenses incurred primarily for and which are essential to medical care may be deducted as medical expenses.
21. Expenses incurred for the production of income, such as legal fees, safe deposit box rentals, etc., may be deducted even though the income produced is wholly tax-exempt.
22. Dividends received on account of stock owned in a life insurance company are not eligible for the dividend exclusion and credit.
23. A, 74 years old, is unmarried. He received dividend income of $\$ 2,000$ during the year, and earned income of $\$ 6,000$. He is not eligible for social security benefits. Because of his earned income, A does not get a retirement income credit.
24. If no tax credit is claimed for income tax paid to a foreign country, it may be deducted as an itemized deduction.
25. An uncollectible real estate contract owned by B, a CPA, for the sale of a small building formerly used for his office is a nonbusiness bad debt.
26. A worthless corporation bond, a capital asset in the hands of its owner, Mr. C, is a nonbusiness bad debt.
27. A machine used by a corporation in its manufacturing process is a capital asset.
28. A taxpayer is unmarried and is not a surviving spouse. He will qualify as a head of household if he maintains a household which constitutes the principal place of abode of himself and an unmarried daughter.
29. Mortgage interest and real estate taxes paid or accrued while a factory is under construction must be capitalized.
30. Payments received for personal injuries which are nonphysical in character, such as injury to personal reputation, are reported as ordinary income.

## Number 2 (Estimated time- 40 to 50 minutes)

On April 30, 1962 Investment Co. agrees to purchase the common stock of Consolidated Co. for a tentative price of $\$ 180,000$. The purchase price is to be reduced by the amount, if any, by which the total book value of the shares of Consolidated Co. as of January 31, 1962 exceeded the total book value as of April 30, 1962.

The balance sheets of Consolidated Co. were as follows:

| Assets | April 30, 1962 | Jan. 31, 1962 |
| :---: | :---: | :---: |
| Current assets | \$ 55,000 | \$ 56,000 |
| Fixed assets, less accumulated depreciation | 76,000 | 78,000 |
| Investment in and advances to Industries, Inc. | 20,200 | 14,100 |
|  | \$151,200 | \$148,100 |

## Liabilities and Owners' Equity

| Current liabilities | \$ 27,000 | \$ 30,000 |
| :---: | :---: | :---: |
| Capital stock | 17,000 | 17,000 |
| Retained earnings | 107,200 | 101,100 |
|  | \$151,200 | \$148,100 |

The balance sheets of Industries, Inc., subsidiary of Consolidated Co., were as follows:

| Assets | April 30, 1962 Jan. 31, 1962 |  |
| :---: | :---: | :---: |
| Current assets | \$ 10,000 | \$ 18,100 |
| Other assets | 1,200 | 1,200 |
| Fixed assets, less accumulated depreciation | 4,300 | 18,600 |
|  | \$ 15,500 | \$ 37,900 |

## Liabilities and Owners' Equity

| Notes payable | \$ 5,000 | \$ 14,300 |
| :---: | :---: | :---: |
| Accounts payable-trade | 5,800 | 8,600 |
| Accrued liabilities | 2,000 | 2,200 |
|  | 12,800 | 25,100 |
| Long-term debt: |  |  |
| Notes payable | 18,500 | 19,400 |
| Advance from Consolidated Co. | 250 | 6,400 |
|  | 18,750 | 25,800 |
| Capital stock | 700 | 1,000 |
| Paid-in capital | 19,250 | 10,000 |
| Deficit | $(36,000)$ | $(24,000)$ |
|  | \$ 15,500 | \$ 37,900 |

The agreement provided that the book value of Consolidated Co. should be determined in accordance with generally accepted accounting principles except that the shares of Industries, Inc., should be included at their book value, if any. In the absence of a book value the liabilities of Consolidated Co. are to be increased by a proportionate amount of the excess of the liabilities of Industries, Inc., over its assets; the proportion shall be the percentage of outstanding stock owned. The excess of liabilities over assets shall be reduced by any loss sustained by Industries, Inc., in the transfer of certain assets to its sole minority stockholder in cancellation of its promissory note.
During the period from January 31, 1962 to April 30, 1962 accumulated advances made by Consolidated Co. in the amount of $\$ 12,250$ were transferred to Paid-in Capital by Industries, Inc.

On March 31, 1962 Industries, Inc. sold certain assets to its minority stockholder in consideration of the cancellation of a note payable to him. The transaction resulted in a book loss of $\$ 6,100$. As part of this transaction the minority stockholder surrendered all of his stock, $30 \%$ of the outstanding stock, to Industries, Inc., for cancellation.

## Required:

a. Prepare schedules showing the net book value of Consolidated Co. at January 31, 1962 and April 30, 1962, computed in accordance with the terms of the sales agreement.
b. Compute the adjustment, if any, to the tentative purchase price.

## Number 3 (Estimated time- 25 to 35 minutes)

In 1961 the Baker Construction Company was awarded a contract to construct a plant for the Ajax Corporation. The contract was for $\$ 2,730,000$ with an escalator clause for changes in labor rates. The contract price was based on estimated costs plus a $5 \%$ mark-up.

Since its contracts are generally long-term, Baker Construction Company recognizes income by the percentage-of-completion method. This method uses the percentage that incurred costs to date bear to estimated total costs after giving effect to estimates of costs to complete based upon most recent information.

At year end the following information is available:

1. Construction labor was originally estimated at 92,000 hours at an average rate of $\$ 3.25$ per hour. To date 65,800 hours have been expended by the labor force and it is estimated that an additional 65,000 hours will be needed to complete the job.
2. Effective January 1, 1962 the construction force union contract provides for a $4 \%$ increase in the basic hourly rate.
3. Material costs were originally estimated at $\$ 1,375,000$. Purchase orders totaling $\$ 1,250,000$ for $90 \%$ of the material have been placed. The remaining materials will cost $7 \%$ more than originally estimated because of general price increases.
4. The electrical work estimated at $\$ 130,000$ was subcontracted for $\$ 127,500$.
5. In a supplemental contract Ajax and Baker agreed that the plant office
should be air conditioned at a contract price of $\$ 42,000$. The subcontractor set a price of $\$ 40,000$ for this extra work.
6. The Baker Construction Company has billed a total of $\$ 1,500,000$ under the terms of the contract. Cash payments by Ajax Corporation totaled $\$ 1,300,000$. Total costs incurred to date aggregate $\$ 1,605,000$.

## Required:

a. Compute the estimated gain or loss on the contract for 1961.
b. Compute the unbilled or excess billed costs on the contract as of December 31, 1961.

## Number 4 (Estimated time- 40 to 60 minutes)

You are engaged to assist in terminating the affairs of T and A Discount Sales, a partnership under liquidation. Allen owns Toy Wholesalers and contributed $\$ 10,000$ in inventory for a $50 \%$ interest in T and A Discount Sales on January 2, 1961. Ball owns Appliance Wholesalers and contributed $\$ 2,000$ cash and $\$ 8,000$ in inventory for a $50 \%$ interest on the same date. All profits and losses are to be shared equally.

T and A Discount Sales was an unsuccessful operation so it was decided to dissolve the partnership after the Christmas shopping season.

In the course of your examination you determine the following facts:

1. An incompetent part-time bookkeeper had discarded all cash register tapes and invoices for expenses and purchases. He was also the bookkeeper for Appliance Wholesalers.
2. The partners state that the only existing payables are to themselves, as follows:

| Toy Wholesalers | \$ 9,740 |
| :---: | :---: |
| Appliance Wholesalers | 5,260 |
|  | \$15,000 |

3. You are able to prepare the following summary of cash transactions from bank statements and cancelled checks:

| Opening cash balanceReceipts: |  | \$ 2,000 |
| :---: | :---: | :---: |
|  |  |  |
| Sales | \$70,000 |  |
| Inventory liquidation | 7,000 | 77,000 |
|  |  | 79,000 |
| Disbursements: |  |  |
| Purchases | 36,000 |  |
| Operating expenses | 26,000 |  |
| Leasehold improvements (5-year lease) | 6,000 |  |
| Liquidating expense | 4,000 | 72,000 |
| Balance, December 31, 1961 |  | \$ 7,000 |

4. On December 31, $1961 \$ 7,000$ was paid to the partners, $\overline{\$ 3,500}$ to each, to apply on the $\$ 15,000$ liability.
5. The partners state that the dollar amounts of regular sales of toys and appliances were approximately equal and that the dollar amounts of liquidating sales of toys and appliances were also approximately equal. There was a uniform mark-up of $40 \%$ of cost on toys and $25 \%$ of cost on appliances. All sales were for cash. The ending inventory of shopworn merchandise was liquidated on December 31, 1961 for $50 \%$ of the retail sales price.
6. The partners believe that some appliances may have been returned to Appliance Wholesalers but the bookkeeper failed to record the returns on the books of either organization.

## Required:

a. Compute the unrecorded amount of appliances returned to Appliance Wholesalers, if any.
b. Prepare an income statement for $\mathbf{T}$ and $\mathbf{A}$ Discount Sales for the period January 2 -December 31, 1961.
c. Prepare a statement of partners' capital accounts.

## Number 5 (Estimated time- 60 to 80 minutes)

On December 31, 1960 Awon Co. was organized and purchased the fixed assets and inventories of Drain Co. at $662 / 3 \%$ of the value reported on the books of the seller. Operations consist of producing iron hardware castings in a foundry and finishing them in a machine shop. Certain finished parts are purchased and installed in the finished castings to meet customer specifications.

Following is the inventory as shown on the records of the seller on December 31, 1960:

|  |  | Pounds |
| :---: | :---: | :---: |
| Raw materials |  | 2,200,000 |
| Work-in-process | (machine shop operations $50 \%$ complete) | 540,000 |
| Finished goods |  | 2,460,000 |

The inventories were priced by the seller in accordance with the following schedule:


In addition, purchased finished parts were carried at a cost of $\$ 180,000$.
At December 31, 1961 the books of Awon Co. show the following information:

| es during the year | \$ 335,360 |
| :---: | :---: |
| Foundry conversion costs | \$1,140,000 |
| Machine shop conversion costs | \$ 822,500 |
| Raw material inventory | 680,000 lbs. |
| Work-in-process inventory |  |
| Rough castings (not machined) | 300,000 lbs. |
| In machining process ( $50 \%$ complete) | 440,000 lbs. |
| Finished goods inventory | 2,660,000 lbs. |
| Purchased parts inventory | \$ 210,000 |

The purchased parts inventory was priced at December 31, 1961 current costs. The average prices for purchased parts at December 31, 1961 were $105 \%$ of the price level prevailing at December 31, 1960.

Intending to avoid taking into operating income any portion of the discount received on the bargain purchase of the inventories, Awon Co. has adopted the last-in, first-out method for pricing inventories.

The Lifo costs for inventory layers are to be determined on a unit-value method except that the purchased parts inventory is to be determined on a dollar-value method. Increments are to be priced at average costs for the year.

## Required:

Prepare a schedule of inventories on Lifo basis as at December 31, 1960 and December 31, 1961 setting forth by layers the number of units, unit costs and amounts. Show all supporting computations in good form.

# EXAMINATION IN ACCOUNTING PRACTICE-PART II 

May 17, 1962; 1:30 to 6:00 p.m.

## GROUP I <br> (Solve all problems in this group.)

## Number 1 (Estimated time- 25 to 35 minutes)

The Lewis Company, a manufacturer of heavy machinery, grants a four-year warranty on its products. The Estimated Liability for Product Warranty account shows the following transactions for the year:

| Opening balance | \$45,000 |
| :---: | :---: |
| Provision | 20,000 |
|  | 65,000 |
| Cost of servicing claims | 12.000 |
| Ending balance | \$53,000 |

A review of unsettled claims and the Company's experience indicates that the required balance at the end of the year is $\$ 80,000$ and that claims have averaged $11 / 2 \%$ of net sales per year.

The balance in Accrued Federal Income Taxes is $\$ 27,000$, which adequately covers any additional liability for prior years' income taxes and includes a $\$ 25,000$ provision for the current year. For income tax purposes only the cost of servicing claims may be deducted as an expense.

The following additional information is available from the Company's records at the end of the current year:

| Gross sales . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . | $\$ 2,040,000$ |
| :--- | :--- | ---: |
| Sales returns and allowances . . . . . . . . . . . . . . . | $1,350,000$ |
| Cost of goods sold . . . . . . . . . | 600,000 |
| Selling and administrative expense . . . . . . . | 600 |
| Net income per books before income taxes . . . | 50,000 |

## Required:

Prepare the necessary adjusting journal entries giving effect to the proper accounting treatment of product warranty and federal income taxes. Support each entry with clearly detailed computations. The books have not been closed. The Company has not allocated income taxes in the past. Assume a rate of $50 \%$ for income tax calculations.

## Number 2 (Estimated time- 35 to 45 minutes)

The December 31, 1961 audit of the Lauren Corporation has been completed and the preparation of the federal income tax return for 1961 is in progress. The following information and data have been developed during the audit:

1. The earned surplus balance at December 31, 1960 was $\$ 785,000$. The net income for 1961 per books was $\$ 210,000$ after providing $\$ 200,000$ for federal income taxes.
2. During 1961 straight-line depreciation of $\$ 1,000,000$ was recorded on the books. Accelerated depreciation of $\$ 2,000,000$ was claimed on the tax return.
3. A reserve for major machinery overhauling is maintained on the books. In $1961 \$ 170,000$ was charged against the reserve for actual expenditures and $\$ 100,000$ was added to the reserve by a provision through current year expenses.
4. During 1961 Lauren Corporation entered the field of leasing equipment to others. At December 31, 1961 lease revenues of $\$ 150,000$ were deferred on the books. The deferral is not permissible for income tax purposes.
5. For federal income tax purposes, bad debt expense is on a charge-off basis. In 1961 a provision of $\$ 200,000$ for bad debts was made and $\$ 40,000$ of uncollectible accounts were charged-off against the bad debt reserve.
6. During the year capital stock was distributed to stockholders. The distribution was recorded by this entry:

7. The Lauren Corporation has investments in subsidiaries which cost $\$ 1,000,000$ in 1955. At the date of acquisition the excess of cost over underlying book value was $\$ 500,000$. This excess is being amortized over a ten-year period.
8. The loss carryover from last year is $\$ 100,000$. Excess contributions from last year total $\$ 10,000$ and current year contributions amount to $\$ 5,000$.

## Required:

a. Prepare a schedule showing the computation of taxable income for 1961.
b. Prepare the "Reconciliation of Taxable Income and Analysis of Earned Surplus and Undivided Profits" (Schedule M) which is to be included in the Lauren Corporation's 1961 federal income tax return. Present any computations or subschedules in good form.

## Number 3 (Estimated time- $\mathbf{4 0}$ to 60 minutes)

Flear Company has a maximum productive capacity of 210,000 units per year. Normal capacity is regarded as 180,000 units per year. Standard variable manufacturing costs are $\$ 11$ per unit. Fixed factory overhead is $\$ 360,000$ per year. Variable selling expenses are $\$ 3$ per unit and fixed selling expenses are $\$ 252,000$ per year. The unit sales price is $\$ 20$.

The operating results for 1961 are: sales, 150,000 units; production, 160,000 units; beginning inventory, 10,000 units; and net unfavorable variance for standard variable manufacturing costs, $\$ 40,000$. All variances are written off as additions to (or deductions from) standard cost of sales.

## Required:

(For items a, b and c assume no variances from standards for manufacturing costs.)
a. What is the breakeven point expressed in dollar sales?
b. How many units must be sold to earn a net income of $\$ 60,000$ per year?
c. How many units must be sold to earn a net income of $10 \%$ on sales?
d. Prepare formal income statements for 1961 under:

1. Conventional costing.
2. "Direct" costing.
e. Briefly account for the difference in net income between the two income statements.

## Number 4 (Estimated time- 50 to 70 minutes)

The president of Rab Co., your client, asks for your assistance because he believes a former employee has stolen a large quantity of finished goods. The employee, who disappeared on May 1, 1962, was the production manager and had access to all production and inventory records. The president requires the information to file a claim with the insurance company.

The Rab Co. manufactures two types of kitchen chairs, All Steel and Open Seat. The legs and frames of the chairs are made of $7 / 8^{\prime \prime}$ metal tubing which is purchased in both random mill lengths and precut $72^{\prime \prime}$ lengths. Each chair has four 24" legs. The All Steel chair frame is made from a $72^{\prime \prime}$ length of tubing; the Open Seat chair frame requires a $36^{\prime \prime}$ length of tubing. The scrap loss in cutting random mill lengths has averaged $3 \%$. Other fabrication losses are negligible.

Under your observation a physical inventory is taken promptly and, by applying cut-off techniques, you determine the following physical inventory at May 1 , 1962. Other chair components are not subject to verification. Your audit working papers for the 1961 audit reveal the inventory quantities at December 31, 1961.

| Raw materials: | 5/1/62 | 12/31/61 |
| :---: | :---: | :---: |
| 72" lengths of tubing | 8,500 | 13,500 |
| Random mill lengths | 34,800 feet | 9,800 feet |
| Work-in-process: |  |  |
| Individual legs | 9,700 | 2,900 |
| All Steel chair frames | 800 | 1,300 |
| Open Seat chair frames | 100 | 300 |
| Finished goods: |  |  |
| All Steel chairs | 5,500 | 10,700 |
| Open Seat chairs | 1,300 | 900 |

Your examination reveals metal tubing purchases during 1962 amounted to 202,000 pieces of $72^{\prime \prime}$ lengths and 125,000 feet of random mill lengths.

You determine that 100,000 chairs were shipped to customers during 1962. Of this number, 10,000 were Open Seat chairs selling for $\$ 3.75$ each. The All Steel chair sells for $\$ 5.00$ each. Your audit work papers show that Rab Co. has generally added $25 \%$ to its manufacturing cost to arrive at selling prices.

## Required:

For insurance claim purposes, compute the amount of the dollar loss sustained by Rab Co., assuming that the types of chairs missing were in the same ratio as the sales.

## GROUP II

> (Estimated time- $\mathbf{4 0}$ to 60 minutes.)
> (Solve one of the two problems in this group. If both are solved, only the first will be considered.)

## Number 5

Information concerning the accounting records of the City of Bruceville at December 31, 1961 is presented below:

## City of Bruceville <br> GENERAL FUND <br> PARTIAL GENERAL LEDGER TRIAL BALANCE (BEFORE ADJUSTMENTS) <br> December 31, 1961

|  | Debit | Credit |
| :---: | :---: | :---: |
| Supplies inventory (physical inventory 12/31/61) | \$10,000 |  |
| Estimated revenue-miscellaneous | 20,000 |  |
| Estimated revenue-taxes | 95,000 |  |
| Appropriations |  | \$112,000 |
| Revenue-miscellaneous |  | 19,900 |
| Revenue-taxes |  | 95,500 |
| Encumbrances | 20,000 |  |
| Expenditures | 80,000 |  |
| Expenditures chargeable against prior years' encumbrances | 7,100 |  |
| Reserve for encumbrances (balance, 1/1/61, \$7,000) |  | 27,000 |
| Reserve for supplies inventory (balance at $1 / 1 / 61$ ) |  | 12,000 |
| Unappropriated surplus |  | 3,300 |
| Surplus receipts |  | 1,700 |

Supplementary information:

1. The unencumbered balance of the fire department's appropriation at December 31, 1961 was $\$ 10,025$. As legally authorized, the City Council voted to carry over to 1962 this balance in the rounded amount of $\$ 10,000$. The action of the City Council has not been recorded in the accounts.
2. Unfilled purchase orders for the General Fund at December 31, 1961 totaled $\$ 20,000$.

## Required:

a. Prepare adjusting journal entry or entries for General Fund accounts at December 31, 1961.
b. Prepare closing journal entry or entries for General Fund accounts at December 31, 1961.
c. Prepare in columnar form an "Analysis of Changes in Unappropriated Surplus" for the year with the following column headings: "Estimated," "Actual," and "Excess of Deficiency of Actual Compared with Estimated."

## Number 6

In 1960 J-P Bowling Company entered into an agreement with a bank for an unsecured long-term loan of $\$ 2,000,000$. The loan agreement provides for interest at $5 \%$ and lump-sum repayment in 1970. Certain terms of the loan agreement placing restrictions on incurring additional long-term debt and payment of dividends are presented in summary:
A. Additional long-term debt shall not be incurred unless the net tangible assets (investments, plant and equipment), adjusted to include the proceeds of such additional long-term debt, will be at least $225 \%$ of the total long-term debt after incurring such additional debt.
B. Long-term debt shall mean the total of all debt outstanding for a period of one year or longer plus an amount equal to the "Capitalized Rent" on unexpired long-term leases of real property. "Capitalized Rent" shall be computed by discounting the aggregate rental obligations under the long-term lease, by years, to the date of the computation at the rate of $5 \%$ per annum.
C. Payment of cash dividends during the period of the loan shall be subject to the following limitations:

1. Working capital of at least $\$ 6,500,000$ shall be maintained.
2. Cash dividends shall not exceed earnings subsequent to December 31, 1959 except that the payment of cash dividends in 1960 may exceed 1960 net income by an amount which is not more than $50 \%$ of the net income for 1959.
3. In 1961 and subsequent years cash dividends shall be limited to $25 \%$ of the prior year's net income.
4. The total annual cash dividends shall not exceed $\$ 2$ per share of stock outstanding at the end of any year.
5. Should cash dividends be paid in excess of restrictions, such excess shall be applied in determining the amounts of dividends which may be paid in subsequent years.
The condensed balance sheet of J-P Bowling Company at December 31, 1961 follows:

| Assets |  |
| :---: | :---: |
| Current assets | \$16,787,000 |
| Investments | 300,000 |
| Plant and equipment | 5,000,000 |
| Goodwill and patents | 400,000 |
|  | \$22,487,000 |
| Liabilities and Owners' Equity |  |
| Current liabilities | \$ 8,290,000 |
| Note payable to bank | 2,000,000 |
| Capital stock (par value \$50) | 3,131,000 |
| Contributed capital in excess of par value | 2,485,000 |
| Retained earnings ...... | 6,581,000 |
|  | \$22,487,000 |

An analysis of the Company's retained earnings for 1959, 1960 and 1961 discloses the following:

Balance, December 31, 1958 . . . . . . . . . . . . . . . . . . . . . . . . . . . . \$ 5,445,000
Net income for 1959 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 422,000
Balance, December 31, 1959 . . . . . . . . . . . . . . . . . . . . . . 5,867,000
Net income for 1960 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 507,000
Cash dividends paid in 1960 . . . . . . . . . . . . . . . . . . . . . . . . . . . $\quad(98,000)$
Balance, December 31, 1960 . . . . . . . . . . . . . . . . . . . . . 6 .276,000
Net income for 1961 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 522,000
Cash dividends paid in 1961 . . . . . . . . . . . . . . . . . . . . . . . . . . . $\quad(124,000)$
$1 \%$ stock dividend-at market value of shares issued ...... $(93,000)$
Balance, December 31, 1961 . . . . . . . . . . . . . . . . . . . . . \$ 6,581,000
The Company has a ten-year lease for a warehouse which expires December 31, 1965. The annual rental is $\$ 40,000$ until December 31, 1962 and $\$ 50,000$ thereafter. Under an option the lease may be extended for another ten years, or portion thereof, at an annual rental of $\$ 60,000$.

The present worth (rounded) of $\$ 1.00$ at compound interest of $5 \%$ is:

| Number of years |  | Number of years |  |  |  | Number of years |  |  |
| :---: | ---: | ---: | ---: | ---: | ---: | ---: | :---: | :---: |
|  | $\$ .952$ | 6 | $\$ .746$ | 11 | $\$ .585$ |  |  |  |
| 2 | .907 | 7 | .711 | 12 | .557 |  |  |  |
| 3 | .864 | 8 | .677 | 13 | .530 |  |  |  |
| 4 | .823 | 9 | .645 | 14 | .505 |  |  |  |
| 5 | .784 | 10 | .614 | 15 | .481 |  |  |  |

## Required:

a. The amount of cash dividends which may be paid under the loan agreement in 1962, including an indication of the application of each of the limitations contained in the loan agreement.
b. The amount of additional long-term debt which may be incurred under the loan agreement as of December 31, 1961.

## EXAMINATION IN AUDITING

May 17, 1962; 8:30 a.m. to $12: 00 \mathrm{~m}$.

## GROUP I

(Answer all questions in this group.)

## Number 1 (Estimated time- 15 to 20 minutes)

a. Your client is a small college in a small town. The college has recently elected as treasurer the president of the local bank in which the college keeps its cash funds. The bank is also the custodian of the college's endowment fund securities. Furthermore, certain short-term securities are held at the bank in a safe deposit box to which the president has access.

Confirmation requests to the bank in the past have been signed by the former college treasurer and the bank's replies have been signed by the bank president.

## Required:

1. What should you do about direct confirmations for the current fiscal year?
2. What effect would these circumstances have on your opinion?
b. Frequently CPAs have continuing engagements during which they write up the client's books, or make numerous adjusting entries, and prepare financial statements.

## Required:

1. What effect do these circumstances have on the CPA's opinion and report if the client requests the auditor's opinion on the financial statements?
2. What disclosure should be made, if any?

## Number 2 (Estimated time- 25 to 30 minutes)

Coil steel comprises one half of the inventory of the Metal Fabricating Company. At the beginning of the year the Company installed a system to control coil steel inventory.

The coil steel is stored within the plant in a special storage area. When coils are received a two-part tag is prepared. The tag is prenumbered and each part provides for entry of supplier's name, receiving report number, date received, coil weight and description. Both parts of the tag are prepared at the time the material is received and weighed and the receiving report prepared. The "A" part of the tag is attached to the coil and the " B " part of the tag is sent to the stock records department with the receiving report. The stock records department files the tags numerically by coil width and gauge. The stock records department also maintains perpetual stock cards on each width and gauge by total weight; in a sense, the cards are a control record for the tags. No material requisitions are used by the plant, but as coils are placed into production, the "A" part of the tag is removed from the coil and sent to stock records as support of the production report which is the basis of entries on the perpetual inventory cards.

When the " A " part of the tag is received by the stock records department, it is matched with the " B " part of the tag and the " A " part is destroyed. The " B " part is stamped with the date of use, processed and retained in a consumed file by width and gauge. The coils are neatly stacked and arranged and all tags are visible.

The balance of the inventory is examined by standard procedures and you are satisfied that it is fairly stated.

Physical inventories are taken on a cycle basis throughout the year. About one twelfth of the coil steel inventories are taken each month. The coil steel control account and the perpetual stock cards are adjusted as counts are made. Internal control of inventories is good in all respects.

In previous years the client had taken a complete physical inventory of coil steel at the end of the year (the client's fiscal year ends December 31) but none is to be taken this year. You are engaged for the current audit in September. You audited the financial statements last year.

## Required:

a. Assuming that you decide to undertake some preliminary audit work before December 31, prepare programs for:

1. The verification of coil steel quantities previously inventoried during the current year.
2. Observation of physical inventories to be taken in subsequent months.
b. What deviation, if any, will be necessary from the standard short-form accountant's opinion because of the client's inventory practices and the audit programs which you have prepared? Explain.

## Number 3 (Estimated time- 25 to 30 minutes)

The Jones Co. is a processor and distributor of wire and cable. An analysis of the Jones Co. sales register reveals that the proceeds received from scrap sales are credited directly to the merchandise inventory account.

Under the Company's accounting system for returnable spools the totals of purchase invoices, including deposits on spools, are charged to merchandise purchases, and the totals of sales invoices, including deposits on spools in the same amounts as billed by the wire manufacturers, are credited to merchandise sales. Credits issued to customers for spools returned to the Jones Co. are recorded as sales returns and allowances and the credits allowed by the wire manufacturers for spools returned by the Jones Co. are recorded as purchase returns and allowances.

A review of the Jones Co. debit and credit memoranda discloses that the inventory account also serves as a suspense and clearing account because credits issued for returnable spools returned by customers directly to wire manufacturers are debited to the inventory account and the subsequent credit issued by the wire manufacturer to the Jones Co. is credited to the inventory account. Periodic journal entries are made to obtain the same ultimate accounting on spools returned directly by customers to the wire manufacturers as for spools returned by customers to the Jones Co.

## Required:

a. What are the disadvantages in the procedures followed by the Jones Co. in accounting for:

1. Sales of scrap.
2. Returnable spools.
b. State your recommended changes, if any, together with your reasons for recommending them, in the Jones Company's method of accounting for:
3. Sales of scrap.
4. Returnable spools.
c. What procedures should the Jones Co. adopt for effective internal control over:
5. Sales of scrap.
6. Returnable spools.

## Number 4 (Estimated time- 25 to 30 minutes)

The Robert Corporation commenced doing business on January 1, 1961. It produces one product which is sold to a single customer, Brown Corporation. Mr. Robert Brown is president of both corporations and owns all of the outstanding stock except for a few qualifying shares.

You have been the CPA for Brown Corporation for some years and accepted the engagement of examining the Robert Corporation financial statements presented on page 187.

## Robert Corporation <br> STATEMENT OF OPERATIONS <br> For Year Ended December 31, 1961

Sales ..... \$150,000
Cost of sales ..... 75,000
Gross profit ..... 75,000
Selling and administrative expenses ..... 55,000
Net profit before taxes ..... 20,000
Provision for federal income taxes ..... 6,000
Net profit ..... $\$ 14,000$
Robert Corporation
BALANCE SHEET
December 31, 1961
Assets
Current assets
Cash ..... \$8,000
Account receivable ..... 15,000
Inventory ..... 16,000
Total current assets ..... \$ 39,000Fixed assets
Land ..... 20,000
Building ..... \$50,000
Allowance for depreciation ..... 48,000
Machinery \& equipment ..... 20,000
Allowance for depreciation ..... 18,000
Total fixed assets ..... 86,000
Total assets ..... $\$ 125,000$
Liabilities
Current liabilities
Accounts payable ..... \$11,800
Liability for federal income taxes ..... 6,000
Total current liabilities ..... \$ 17,800
Long-term liabilities
Mortgage payable ..... 43,200
Stockholders' equity
Capital stock, authorized and issued, 100 shares at $\$ 100$ par value ..... 10,000
Retained earnings ..... 54,000
Total stockholders' equity ..... 64,000
Total liabilities and stockholders' equity ..... $\$ 125,000$

Management co-operated in every respect during the audit. You did not confirm the account receivable. All other generally accepted auditing procedures were followed, and no items of importance were revealed by the audit except the following:

1. The selling and administrative expenses included Mr. Brown's salary of \$35,000.
2. The client had made a $\$ 1,000$ writedown to adjust the finished goods inventory to the lower of average cost or market.
3. Land, building, machinery and equipment are recorded at current market values determined as of January 1, 1961 by a qualified appraiser. Mr. Brown purchased the assets from Brown Corporation at net book value and contributed them as part of his investment in Robert Corporation. The net book values on the records of Brown Corporation were:

| Land | \$10,000 |
| :---: | :---: |
| Building | 25,000 |
| Machinery and equipment | 10,000 |
|  | \$45,000 |

4. Depreciation was computed on the straight-line method.
5. The mortgage payable is the balance due on a ten-year, $5 \%, \$ 48,000$ mortgage payable to the First National Bank in equal annual instalments. The mortgage is secured by the Company's fixed assets and is guaranteed by Mr. Brown.
6. The Company customarily contracts for raw materials on a quarterly basis. An audit of post-balance-sheet events revealed that the quarterly raw material contract for the first quarter of 1962 calls for a price increase of $10 \%$.
7. The sales prices to Brown Corporation were approximately $25 \%$ above competitive prices.
8. The usual inventory and liability certificates were signed by Mr. Brown.

## Required:

(Disregard the income tax problems arising from the intercorporate relationship and the control by a single stockholder.)
a. State briefly the adjustments you would suggest that the client make to his financial statements. Formal journal entries are not required.
b. Prepare the footnotes that you would suggest for the financial statements.
c. Assuming that the client adopts your suggested adjustments and footnotes, prepare the auditor's opinion. The scope paragraph should be omitted. If your report is in any way modified or qualified as to opinion, give your reasons.

## Number 5 (Estimated time- 25 to 35 minutes)

In your examination of the financial statements of Gaar Corporation at December 31, 1961 you observe the contents of certain accounts and other pertinent information as follows:

| Date | Explanation | $\frac{\text { Building }}{L F}$ | Debit | Credit | Balance |
| :---: | :---: | :---: | :---: | :---: | :---: |
| $\overline{12 / 31 / 60}$ | Balance | X | \$100,000 |  | \$100,000 |
| 7/1/61 | New boiler | CD | 16,480 | \$ 1,480 | 115,000 |
| 9/1/61 | Insurance recovery | CR |  | 2,000 | 113,000 |
| Allowance for Depreciation-Building |  |  |  |  |  |
| Date | Explanation | LF | Debit | Credit | Balance |
| $\overline{12 / 31 / 60}$ | $\begin{array}{r} \text { Balance-15 years @ } \\ 4 \% \text { of } \$ 100,000 \ldots \end{array}$ | $\boldsymbol{X}$ |  | \$60,000 | \$ 60,000 |
| 12/31/61 | Annual depreciation . . | GJ |  | 4,440 | 64,440 |

You learn that on June 15 the Company's old high-pressure boiler exploded. Damage to the building was insignificant but the boiler was replaced by a more efficient oil-burning boiler. The Company received $\$ 2,000$ as an insurance adjustment under terms of its policy for damage to the boiler.

The disbursement voucher charged to the building account on July 1, 1961 is reproduced below:

## To: REX HEATING COMPANY

| List price-new oil-burning boiler (including fuel oil tank and 5,000 gallons fuel oil) | \$16,000 |
| :---: | :---: |
| Sales tax-3\% of \$16,000 | 480 |
| Total | 16,480 |
| Less: |  |
| Allowance for old coal-burning boiler in building-to at the expense of the Rex Heating Company ... | 1.480 |
| Total price | \$15. |

In vouching the expenditure you determine that the terms included a $2 \%$ cash discount which was properly computed and taken. The sales tax is not subject to discount.

Your audit discloses that a voucher for $\$ 1,000$ was paid to Emment Co. on July 2, 1961 and charged to the repair expense account. The voucher is adequately supported and is marked "installation costs for new oil-burning boiler."

The Company's fuel oil supplier advises that fuel oil had a market price of $16 \phi$ per gallon on July 1 and $18 \phi$ per gallon on December 31. The fuel oil inventory at December 31 was 2,000 gallons.

A review of subsidiary property records discloses that the replaced coalburning boiler was installed when the building was constructed and was recorded at a cost of $\$ 10,000$. According to its manufacturers the new boiler should be serviceable for 15 years.
In computing depreciation for retirements Gaar Corporation consistently treats a fraction of a month as a full month.

## Required:

Prepare the adjusting journal entries that you would suggest for entry on the books of Gaar Corporation. The books have not been closed. Support your entries with computations in good form.

## Number 6 (Estimated time-25 to 30 minutes)

Frequently questions have been raised ". . . regarding the responsibility of the independent auditor for the discovery of fraud (including defalcations and other similar irregularities), and concerning the proper course of conduct of the independent auditor when his examination discloses specific circumstances which arouse his suspicion as to the existence of fraud."

## Required:

a. What are the (1) function and (2) responsibilities of the independent auditor in the examination of financial statements? Discuss fully, but in this part do not include fraud in the discussion.
b. What are the responsibilities of the independent auditor for the detection of fraud? Discuss fully.
c. What is the independent auditor's proper course of conduct when his examination discloses specific circumstances which arouse his suspicion as to the existence of fraud?

## GROUP II

## (Estimated time-25 to 35 minutes)

(Answer only one question in this group.
If both are answered, only the first will be considered.)

## Number 7

As a certified public accountant you have been asked to examine and give your opinion on pro forma financial statements of a client.

## Required:

a. Define pro forma financial statements.
b. List and briefly discuss the conditions necessary for giving an opinion on pro forma financial statements.

## Number 8

In the development of an audit program it is determined that to achieve specified precision and confidence a sample of 436 items from a population of 10,000 is adequate on a statistical basis.

## Required:

a. Briefly define each of the following terms used in the above statement:

1. Population.
2. Sample.
3. Precision.
4. Confidence.
b. If the population is 100,000 and the specifications for precision and confidence are unchanged from the situation above for a population of 10,000 , which of the following sample sizes could be expected to be statistically correct for the larger population: 436; 454; 3,000; 4,360? Justify your answer. (Your answer should be based on judgment and reasoning, rather than actual calculation.)
c. Statistical sampling techniques are being used in auditing. A sample is taken and analyzed to draw an inference or reach a conclusion about a population, but there is always a risk that the inference or conclusion may be incorrect. What value, then, is there in using statistical sampling techniques?

# EXAMINATION IN COMMERCIAL LAW 

## May 18, 1962; 8:30 a.m. to $12: 00 \mathrm{~m}$. <br> (All questions are required.)

## Number 1 (Estimated time- 20 to $\mathbf{3 0}$ minutes)

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether each of the legal conclusions is true or false according to the general principles of contract law. Mark your answer sheet indicating whether each conclusion is true or false. Your grade will be determined by deducting your total of incorrect answers from your total of correct answers; if you omit an answer it will not affect either total.

For example:

Question
XX. The right of subrogation may arise under:

1. Life insurance policies.
2. False
3. Fire insurance policies.
4. Marine insurance policies.
5. Automobile collision insurance policies
6. None of the above.
7. True
8. True

## Answer

4. True
5. False
A. In order to be legally effective an offer must:
6. Be in writing if it is for the sale of goods valued in excess of $\$ 500$.
7. Be communicated to the offeree.
8. Be such that the reasonably prudent offeree would understand that it was made with an intent to contract.
9. Specifically identify the particular offeree.
10. Indicate a fixed duration during which it can be accepted.
B. Silence by the offeree:
11. Is normally not an acceptance.
12. Can be an acceptance if prior dealings have created this understanding between the parties.
13. Is one way by which the offer may be terminated.
14. Will be an acceptance if the offeror indicated he would consider silence as an acceptance.
15. None of the above.
C. In order to be effective when posted, an acceptance must be:
16. Properly addressed.
17. Received by the offeror.
18. Posted prior to the time of the offeror's posting his revocation.
19. Transmitted by the means of communication expressly or impliedly authorized by the offeror.
20. None of the above.
D. If A receives an offer by telegraph, he can:
21. Only accept by return telegraph.
22. Use his own messenger to communicate acceptance, but the acceptance will not be effective until the time of receipt.
23. Accept by telegraph and thus assure the benefit of an acceptance at the time of delivery of the message to the telegraphic service.
24. Accept by mail and thus assure the benefit of an acceptance at the time of posting.
25. None of the above.
E. An offer to enter into a bilateral contract may be accepted:
26. By performance of the act sought by the offeror if the act is performed and notice of the performance is given within the time allowed for acceptance.
27. Either orally or in writing.
28. Only if the offeree is aware of the offer at the time of acceptance.
29. By a qualified counterpromise.
30. None of the above.
F. If a reward is offered for the capture of a criminal:
31. Acceptance need not be made with knowledge of the reward.
32. A promise to perform will be a valid acceptance.
33. The offer is an excellent example of an offer to enter into a unilateral contract.
34. The contractual requirements of acceptance and consideration are both fulfilled by performance of the act requested.
35. None of the above.
G. An offer is terminated:
36. Immediately upon the death of the offeror.
37. At the time of posting of a revocation if the original offer was made by mail.
38. At the time of posting of a counteroffer if the offer was received by mail.
39. If the subject matter of the contract is sold and the offeree has knowledge of this fact prior to his acceptance.
40. By the lapse of time indicated in the offer.
H. An option:
41. Is normally revocable even though it states it is irrevocable.
42. Is not revocable if supported by some independent consideration.
43. Must be in writing to be valid as an offer.
44. May be effective as a contract in some jurisdictions if it is in writing and states its irrevocability.
45. Can only be accepted in writing by the offeree.
I. The following will constitute consideration:
46. The recitation of consideration in a contract.
47. A promise, but only if it has pecuniary value.
48. An illusory promise.
49. The promise to refrain from commission of an illegal act.
50. None of the above.
J. If $\mathbf{X}$ and $\mathbf{Y}$ enter into an illegal bargain:
51. The contract is void.
52. The contract is voidable.
53. Neither $\mathbf{X}$ nor $\mathbf{Y}$ may obtain any relief in a court of law, but equity will normally intervene to prevent unjust enrichment.
54. $Y$ may recover the consideration he has parted with if he is not in pari delicto (equally guilty).
55. None of the above.
K. The failure to obtain a license will result in an illegal bargain in the following situations:
56. If the licensing statute is in reality a revenue raising measure.
57. Only if the party contracting with the unlicensed party was unaware of the fact that the license had not been obtained.
58. If the licensing statute is regulatory in nature.
59. Only if the unlicensed party could not have met the requirements.
60. None of the above.
L. X owes Y $\$ 1,000$. Y, wishing to make a present to his wife ( $\mathbf{W}$ ) and to satisfy a claim of C, a creditor, obtains X's promise to pay one half to $W$ and the other half to $C$.
61. $W$ is an incidental beneficiary and $C$ is a creditor beneficiary.
62. Both W and C may enforce the obligation against X .
63. W's rights are vested at the time X promises Y he will pay W one half.
64. W is a donee beneficiary and C is a creditor beneficiary.
65. Any defense that the debtor, X , could assert against Y he may assert against either W or C.
M. An assignment of a claim to money owed:
66. Must be in writing to be legally effective irrespective of the amount.
67. Is a common example of a chose in action.
68. Is a personal obligation and, as such, is nonassignable.
69. Is collectible by the assignee against the debtor even if the debtor pays the original creditor without knowledge of the assigument.
70. None of the above.

N . The parole evidence rule does not apply to:
66. Subsequent oral modifications of a written contract.
67. Written agreements which were obtained by duress.
68. Prior oral agreements which would normally have been included in the written contract.
69. Oral agreements relating to and made contemporaneously with the written contract.
70. Those provisions in the contract which are obviously ambiguous.
O. Delegation of a contractual duty:
71. May be precluded by an appropriate provision in the contract.
72. May be forbidden by statute.
73. Will not be effective if a materially different performance would result.
74. Is not permissible in the majority of states.
75. Will not be effective if the contract calls for unique skill by the original party.

## Number 2 (Estimated time- 20 to 30 minutes)

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether each of the legal conclusions is true or false according to the general principles of corporation law. Mark your answer sheet indicating whether each conclusion is true or false. Your grade will be determined by deducting your total of incorrect answers from your total of correct answers; if you omit an answer it will not affect either total.
A. X has purchased $\$ 10$ par value stock of Y Corporation from the $\mathbf{Y}$ Corporation for $\$ 5$ per share.
76. X will have no liability to creditors of the Corporation if he purchased treasury stock.
77. If X sold the stock to Z for $\$ 5$ and Z took it without knowledge of the original purchase for less than par, Z will have no liability to creditors of the Corporation.
78. If X sold the stock to Z for $\$ 5$ and Z took it without knowledge of the original purchase for less than par, X will be liable to the creditors for the difference between par and the price he paid.
79. One basis for imposition of liability upon those who pay less than par for par value stock is the creditor's supposed reliance upon the legal capital of the corporation.
80. None of the above.
B. "Watered stock" in a corporation:
81. May occur even though par value is paid.
82. Occurs when property which has been overvalued is transferred to the corporation for its stock.
83. Can be avoided by a fair and impartial valuation.
84. Will give rise to a shareholder's derivative action against the directors who wrongfully permitted the issuance of the stock.
85. Refers to stock that has fallen in value below its original par value.
C. A stock certificate:
86. Is a negotiable instrument within the meaning of the Uniform Negotiable Instruments Law.
87. Indorsed in blank by the holder of record becomes a bearer instrument.
88. Indorsed in blank by the holder of record, subsequently stolen, and then sold by the thief to an innocent purchaser, will pass with good title to the innocent purchaser.
89. Which bears the forged indorsement of the holder of record will be held with good title by an innocent purchaser.
90. None of the above.
D. Restrictions on the transfer of stock certificates:
91. Are valid, even though they absolutely prohibit transfer, if they are included in the corporate charter and on the face of the stock certificates.
92. Are not valid against any party unless stated on the stock certificate.
93. Are most commonly associated with closed corporations.
94. Are valid if stated in terms of the right of first refusal by the corporation.
95. Are invalid as a matter of public policy.
E. The A Corporation, pursuant to state corporation law, combines with the B Corporation to form the X Corporation.
96. The above fact situation describes a statutory merger.
97. The above fact situation describes a statutory consolidation.
98. Whether it be a merger or a consolidation, X Corporation will be liable for the debts of the A and B Corporations.
99. Dissenting shareholders of the A and B Corporations will have a right of appraisal and payment for their shares.
100. Such a combination may be illegal under the federal anti-trust laws.
F. X Corporation is incorporated in state $\mathbf{A}$ but does business in states $\mathrm{A}, \mathrm{B}$ and C .
101. X is a foreign corporation insofar as states B and C are concerned.
102. Since $X$ is doing business in states $B$ and $C$, it must qualify, i.e., be licensed to do business, in those states.
103. If X does business without qualifying it will be denied access to the courts in states B and C.
104. X is a domestic corporation insofar as state A is concerned.
105. None of the above.
G. Cumulative voting:
106. Is mandatory in all states.
107. Permits a shareholder to multiply the number of shares he owns by the number of directors to be elected and then cast the total for a single director.
108. May result in the minority electing more directors than the majority.
109. Is invariably used and associated with cumulative preferred stock.
110. None of the above.
H. The common law pre-emptive right, i.e., the right to subscribe to newly issued stock, applies:
111. Unless specifically negated.
112. To debentures convertible into voting stock.
113. To nonvoting preferred stock.
114. To treasury stock.
115. None of the above.
I. The Securities Act of 1933:
116. Created the Securities and Exchange Commission.
117. Is concerned exclusively with securities which are traded on organized stock exchanges.
118. Applies to all publicly offered securities.
119. Is known as the "truth in securities" act.
120. Is primarily based upon full disclosure of facts as the method of protecting the public.
J. The issuance of financial statements to shareholders:
121. Is required by most states.
122. Will prevent the shareholder from inspecting the books if the statements are properly certified.
123. May, in some states, be demanded by shareholders owning a stated percentage of stock.
124. Is normally undertaken voluntarily by most corporations.
125. None of the above.
K. The directors of a corporation:
126. May vote by proxy.
127. Elect the president of the corporation.
128. Are limited in their actions by the corporation bylaws.
129. Normally must act as a unit with the requisite quorum present.
130. May delegate some of their functions to an executive committee made up of some of the directors.
L. A duly elected director:
131. Is disqualified from continuing as a director if he becomes bankrupt.
132. Is ordinarily not entitled to any compensation as a matter of law.
133. Can always be removed for cause.
134. Can be removed at any time, even without cause, if the bylaws or charter so provide.
135. Is known as a de facto director.
M. Provided public notice of declaration is given, a dividend becomes an irrevocable debt of the corporation as soon as it is declared, even though:
136. The declaration is illegal.
137. It is revoked at the next meeting and the meeting takes place before payment.
138. A stock dividend is declared and the stock has not been issued.
139. It is an extra dividend, i.e., given in addition to the regularly declared dividend.
140. None of the above.
N. A corporation which has been legally dissolved:
141. Cannot act as a corporate entity unless authorized to do so by statute for the purpose of concluding its business.
142. Has all its debts extinguished.
143. Holds the corporate property for the benefit of the shareholders, subject to the prior payment of corporate debts.
144. Will nevertheless be liable on its executory contracts such as leases.
145. None of the above.
O. Able, a shareholder of the X Corporation, demands access to the corporate shareholder lists, books and records.
146. Access to the lists, books and records can be validly denied if Able is a minority shareholder.
147. Access to the lists, books and records can be validly denied if Able has been a shareholder for less than three months.
148. Able's right of access to the lists, books and records is an absolute right according to common law.
149. Access cannot be denied on the grounds that Able's sole purpose is to obtain evidence to bring a derivative suit against the directors.
150. Even if access to the lists, books and other records is wrongfully denied, Able's only recourse is to seek redress at the next shareholders' meeting.

## Number 3 (Estimated time- 20 to 30 minutes)

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether each of the legal conclusions is true or false according to the general principles of law and provisions of the applicable Uniform Law. Mark on your answer sheet indicating whether each conclusion is true or false. Your grade will be determined by deducting your total of incorrect answers from your total of correct answers; if you omit an answer it will not affect either total.
A. Assignments differ from negotiable instruments in that:
151. An assignment may be oral whereas a negotiable instrument must be in writing.
152. The assignee of an account receivable takes the account receivable subject to all the defenses between the original parties, whereas a holder in due course of a negotiable instrument takes the negotiable instrument free of many such defenses.
153. Assignments are not limited to the right to payment of money whereas negotiable instruments are so limited.
154. Consideration is presumed in respect to assignments but not as to negotiable instruments.
155. None of the above.
B. To be negotiable an instrument must:
156. Contain a statement of the transaction out of which the instrument arose.
157. State that it was given "for value received."
158. If it is a bill of exchange, indicate the drawee with reasonable certainty.
159. Contain the words "to order or bearer" or words of like import. 160. None of the above.
C. The requirement of "a sum certain in money" is fulfilled even though:
161. The instrument is payable in stated installments.
162. Attorney's fees and other costs of collection are included in the instrument.
163. It is payable in Mexico in Mexican pesos.
164. The instrument states that it will carry the maximum legal interest rate.
165. The instrument is payable in something other than money at the option of the maker or drawer.
D. A check is:
166. One type of bill of exchange.
167. Payable at a fixed future time.
168. Drawn on a bank.
169. Intended to circulate for shorter periods of time than most other negotiable instruments.
170. None of the above.
E. An instrument does not contain an unconditional promise to pay if it:
171. Recites the consideration for which it was given.
172. States that it is subject to another agreement.
173. Indicates the account to be debited upon payment.
174. Indicates it is payable out of a partner's share of profits.
175. None of the above.
F. An instrument will fulfill the time requirement insofar as negotiability is concerned if it is payable:
176. On demand.
177. At a fixed time after presentment.
178. Upon the happening of a contingency if the contingency does in fact occur.
179. June 1, 1962.
180. None of the above.
G. If an instrument is nonnegotiable:
181. It may nevertheless be transferred by assignment.
182. The bona fide purchaser for value will cut off personal defenses.
183. A thief can transfer no better title than he has.
184. Consideration is presumed.
185. None of the above.
H. At the time of original issue of a bill of exchange:
186. The drawer is secondarily liable on the instrument.
187. The drawee has no liability to the payee on the instrument.
188. The drawee has no liability to the payee, but he becomes secondarily liable upon acceptance.
189. The drawer is secondarily liable, but he becomes primarily liable upon acceptance.
190. None of the above.
I. The qualified indorser:
191. Has impaired further negotiability of the instrument.
192. Is free from any personal liability on the instrument.
193. Makes the recipient of the instrument his agent for collection.
194. Reduces the extent of the indorser's warranty liability.
195. Need not be given notice of dishonor.
J. A negotiable instrument which is initially payable to order may be:
196. Negotiated by mere delivery of the instrument to the transferee.
197. Converted to bearer paper by a blank indorsement.
198. Transferred without indorsement, but the transferee will not qualify as a holder in due course until indorsement.
199. Either a bill of exchange or a promissory note.
200. Converted to bearer paper and then converted back to order paper.
K. An accommodation comaker:
201. Must be given notice of dishonor.
202. Is discharged by a binding extension of time.
203. Is secondarily liable only insofar as the maker he accommodated is concerned.
204. Can assert certain personal defenses which the ordinary maker cannot.
205. Will be secondarily liable to any subsequent party who was aware of his signing as an accommodation party.
L. Notice of dishonor:
206. Need not be given to an accommodation indorser.
207. Must be given to all parties.
208. Can be waived by an indorser.
209. Must be in writing.
210. Must be given upon dishonor of bills of exchange but need not be given upon dishonor of notes.
M. The following defenses are known as real defenses:
211. Lack of delivery.
212. Duress in the inducement.
213. Wrongful filling in of blank spaces.
214. Payment.
215. Fraud in the execution.

N . If the bank pays on the forged signature of the payee:
216. It must credit the drawer's account for the amount that it wrongfully paid.
217. It may sue and recover from the party receiving payment the amount paid even though that party is a holder in due course.
218. It will not be liable to its depositor if it could not have detected the forgery.
219. It is liable to the payee for conversion.
220. None of the above.
O. Certification of a check by a bank:
221. Makes the bank primarily liable regardless of whether the drawer or payee secured the certification.
222. Will release all secondarily liable parties if the holder procures the certification.
223. Will make the bank liable for the full amount even though it has certified an overdraft.
224. Will preclude the bank from honoring a stop order.
225. None of the above.

## Number 4 (Estimated time- 15 to 20 minutes)

a. John leased property from Chester. Stanley, a friend of John's, orally promised Chester to pay if John defaulted. The lease was in writing and provided for a five-year tenancy at $\$ 700$ per month. Two years later John negotiated a modification of the lease which provided that in exchange for an increased rental payment of $\$ 25$ per month the entire building was to be air conditioned. John subsequently defaulted. Now Chester is attempting to hold Stanley for the rental as modified, $\$ 725$ per month, or at least for the rental specified in the original lease. Stanley asserted two defenses: (1) The modification was without his consent and, therefore, released him; (2) his promise was not in writing.

1. Will Stanley prevail based solely upon the defense of modification? Explain.
2. Will Stanley prevail based solely upon the defense of the Statute of Frauds? Explain.
b. Smith is a cosurety and has completely satisfied the obligation owed to the creditor by the principal debtor. List, explain and illustrate the three possible rights that Smith may assert in order to recoup all or part of his loss.

## Number 5 (Estimated time-20 to 25 minutes)

a. Mr. Lawrence rented an apartment in the Regency House. He was an elderly gentleman and felt the heat very badly. His apartment was fully airconditioned and in this way he was able to stand the otherwise unbearable heat of the summer. The landlord was dissatisfied with the current rental and, although the lease had a year to run, insisted that Mr. Lawrence agree to an increase. Mr. Lawrence refused. In fact, he was desirous of leaving the Regency House but did not want to abandon the premises because he feared he would be liable for the balance of the term of the lease. The landlord attempted to force Mr. Lawrence to pay the increase by turning off the electricity and thereby stopping the apartment's air-conditioners. He also sent up heat on the hot days. After one week of such treatment Mr. Lawrence, claiming he had been evicted, moved out.

1. What is the difference between an actual and constructive eviction?
2. In this case, has there been an eviction? Explain.
b. George signed a two-year lease which contained a clause which expressly prohibited subletting. After six months George asked the landlord for permission to sublet the apartment for one year. The landlord refused. This angered George and he immediately assigned his rights under the lease to William. William was a distinguished gentleman and George knew that everyone would consider him a desirable tenant.
3. What is the difference between an assignment of a lease and a sublease?
4. Can George validly assign his lease of the apartment to William? Explain.
c. Henry leased an apartment for one year. The landlord sought an increase over the prior rental but the negotiations broke down. The year expired and Henry did nothing. He remained on the premises in the hope that he could continue under the old rental. There is no emergency rent law in force.
5. What is the type of tenancy under which Henry is currently occupying the premises?
6. What optional remedies does the landlord have in respect to Henry's occupancy of the premises?

## Number 6 (Estimated time- 20 to 25 minutes)

a. Peter, a minor, engaged his brother-in-law, Allen, as his agent for the purchase of a used sports car from Tom. Allen knew that Peter was a minor, and that Tom did not know this, but made the purchase to accommodate Peter. He acted without compensation and with a written authorization to make the purchase. At the time of the sale Allen exhibited the authorization to the seller and signed the contract in such a way as to clearly indicate he was acting in an agency capacity. Peter, after driving the car for several days, decided he could obtain a better deal elsewhere. He disaffirmed the contract, stopped all payments and returned the car to Tom. Tom seeks to hold Peter or Allen to the contract. May he do so? Explain.
b. Stephen, a traveling salesman for Ace Television, sold Tom a color television set for $\$ 500$. Stephen did not have the set in his possession but it was to be shipped in one week. The bill of sale clearly indicated that Stephen was authorized to collect $10 \%$ of the purchase price as a down payment. A week later, after Tom had received the set from Ace Television, Stephen, without authority, obtained payment of the balance. He absconded with all the money and Ace Television seeks to recover the full purchase price from Tom. Can Ace Television recover? If so, how much? Explain.
c. Andrew, as agent for Harold, made a particularly desirable written contract with Terrance for the sale of real estate. Terrance, realizing he has made a bad bargain, seeks to avoid the contract. He learns that prior to the time the contract was made Harold had a fatal heart attack. This was unknown to either party at the time the contract was made and both parties acted in good faith. The executor of Harold's estate seeks to enforce the contract against Terrance. Can Terrance avoid liability? Explain.
d. List two exceptions to the general rule that an undisclosed principal is liable on the contracts made by his agent acting within the scope of his authority.

## Number 7 (Estimated time- 20 to 25 minutes)

a. Jack, who owned Blackacre, obtained a $\$ 10,000$ loan from a bank, giving the bank his bond (promise to pay) secured by a real property mortgage on Blackacre. The mortgage was duly recorded. Jack subsequently sold Blackacre to Roger, expressly warranting that there were no mortgages on the property. Roger was unaware of the bank's interest in the property. Jack has disappeared and the bank has demanded payment from Roger. Roger has refused and the bank is seeking to forclose its mortgage.

1. Does Roger have any personal liability on the debt? Explain.
2. May the bank foreclose its mortgage? Explain.
3. Will the bank's rights be superior or inferior to Roger's? Explain.
4. If the bank had not recorded the mortgage but Roger was aware of the bank's mortgage, would the result be different? Explain.
5. What is meant by the mortgagor's equity of redemption in connection with real property mortgages?
b. List and explain the five common law elements or requirements that must be shown in order to obtain title by adverse possession.

## Number 8 (Estimated time-20 to 25 minutes)

a. Norman bought a six-foot stepladder from the local hardware store. It was expressly warranted, by both the manufacturer to the retailer and the local hardware store to Norman, that this kind of ladder would withstand pressure of 300 pounds. The first time Norman used the ladder a rung broke and he fractured his ankle. An examination of the rung revealed that it had contained a hidden defect in the wood. Moreover, it was shown that if the rung in question had been subjected to pressure of 50 pounds it would have broken. It was the custom of the industry to test ladders by applying 300 pounds of pressure to each rung. The manufacturer of this particular ladder used a random sampling technique instead of testing each rung.

1. Can Norman recover against the manufacturer on the basis of breach of warranty? Explain.
2. Suppose that Norman could not recover on the basis of breach of warranty or there had been no express warranty and that all implied warranties had been effectively disclaimed. Could Norman recover against the manufacturer on a different theory? Explain.
b. A college bookstore ordered 100 copies of a standard accounting text from the publisher. The contract is ambiguous as to whether a "sale on approval" or a "sale or return" was intended. Two days after receipt of the books they were inadvertently damaged when a water pipe burst and flooded the storeroom. Which type of sale will the publisher argue was intended by the parties? Why? Explain.
c. 1. What is meant by the term "bulk sale" as it is used in the various bulk sales acts?
3. For whose protection were bulk sales acts passed?
4. What is the underlying evil or wrong that the bulk sales acts attempt to remedy? Explain.
5. What is the usual effect of a bulk sale when the bulk purchaser has failed to comply with the provisions of the applicable bulk sales act? Explain.

## EXAMINATION IN THEORY OF ACCOUNTS

May 18, 1962; 1:30 p.m. to 5:00 p.m.
(All questions are required.)

## Number 1 (Estimated time- 10 to 15 minutes)

On a separate answer sheet write in the letter of the answer choice which best completes each statement. Mark only one answer for each numbered statement.

1. The term "realized income" refers to:
a. The recording of revenue at the time cash is received from the sale of a commodity or service.
b. The accounting for income in the period in which it is actually earned.
c. The recognition of revenue when there is sufficient objective evidence to determine with a fair degree of certainty the final amount to be received from operations.
d. The recognition of gain when there is good evidence that an asset has changed in value.
e. None of the above.
2. The term "matching costs and revenues" means:
a. That all expenses should be allocated to accounting periods on the basis of the effect on net income.
b. That costs should be carried forward to future accounting periods if they have not resulted in revenue during the current accounting period.
c. That if costs are charged off as expenses in the accounting period when they are actually incurred, they will be matched properly with the revenues actually earned during that accounting period.
d. That costs which can be associated directly with specific revenue should be carried forward in the balance sheet until the associated revenue is recognized.
e. None of the above.
3. The "going concern" concept is the basis for the rule that:
a. The cost of installing a machine should be added to the invoice cost of the machine in the accounts.
b. The cost of intangible assets should be written off systematically over their useful lives.
c. The income statement should not include material gains and losses unrelated to normal operations.
d. Treasury stock should not be recorded in the balance sheet as an asset.
e. None of the above.
4. For accounting purposes the term "current assets" is used to designate cash and other assets or resources commonly identified as:
a. Those which can be liquidated in the normal course of business during the following fiscal year.
b. Those which will be realized in cash or sold or consumed during the normal operating cycle of the business.
c. Those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.
d. Those which can be used for the payment of current liabilities or consumed during the normal operating cycle of the business.
e. None of the above.
5. The primary basis of accounting for inventories is cost. A departure from the cost basis of pricing the inventory is required when:
a. The general price level has changed materially.
b. The Lifo method of inventory valuation is adopted.
c. There is evidence that the replacement cost of the goods when they are sold will be less than their cost.
d. There is evidence that the utility of the goods, in their disposal in the ordinary course of business, will be less than cost.
e. There is evidence that the goods will not be sold at a profit.
6. As used in the phrase "lower of cost or market" the term "market" means current replacement cost except that:
a. Market should not exceed the estimated selling price less reasonably predictable cost of completion and disposal.
b. Market should not be less than net realizable value.
c. Market should not exceed cost plus an allowance for an approximately normal profit margin.
d. Changes in replacement costs should not be due to changes in price levels.
e. None of the above.
7. The term "betterment" refers to:
a. An expenditure made for new facilities which increase "capacity."
b. An expenditure made to restore "capacity" after abandonment or retirement.
c. An expenditure made to improve existing facilities by increasing "capacity."
d. An expenditure made to help insure continuity of service "capacity."
e. None of the above.
8. With respect to the allocation of income taxes, it is recommended that:
a. Because of the difficulty in making allocations and because of the uncertainty of tax rates, no allocation should be attempted.
b. Because income taxes are an expense they should be allocated to income and retained earnings accounts of the same period, but they should not be allocated to other accounts which will affect the income of other periods.
c. Allocation of income taxes should be made so long as the amount shown for income taxes in the income statement is not increased beyond the amount of the tax estimated to be actually payable.
-d. Because income taxes are an expense, they should be allocated to income and other accounts affecting the income of the current period or affecting the income of the current and future periods.
e. None of the above.
9. When a pension plan is first adopted, the costs based on past services of the employees should be treated as follows:
a. They should be charged to income accounts in the years in which they are paid.
b. They should be charged to retained earnings because the services have been received in the past.
c. They should be charged to operations of the current and future periods on a systematic amortization basis.
d. They should be carried on the books indefinitely as long as the pension plan is in existence.
e. None of the above.
10. When bonds have been refunded, the preferred treatment for unamortized discount, issue cost, and redemption premium on these bonds is as follows:
a. They should be written off directly against income or retained earnings.
b. They should be amortized over the remaining years of the original life of the issue retired.
c. They should be amortized over the life of the new issue.
d. They should be carried on the books as an asset.
e. None of the above.

## Number 2 (Estimated time- $\mathbf{8}$ to 10 minutes)

The accounts listed below frequently appear in municipal accounting records. On a separate answer sheet list the letter(s) next to the account indicating the municipal funds in which these accounts might properly appear. An account might appear in more than one fund. Your grade will be determined by your total of correct answers.

Accounts

1. Bonds Payable
2. Reserve for Encumbrances
3. Matured Bonds Payable
4. Bonds Authorized-Unissued
5. Equipment
6. Appropriation
7. Estimated Revenues
8. Taxes Receivable-Current
9. Interest Payable in Future Years
10. Contracts Payable-Retained Percentage

Municipal Accounting Funds
a. General
b. Special Revenue
c. Bond
d. Special Assessment
e. Sinking
f. Working Capital
g. Trust and Agency
h. Utility or Other Enterprise
i. General Fixed Assets
j. General Bonded Debt and Interest

## Number 3 (Estimated time- 15 to 25 minutes)

At the regular meeting of the Board of Directors of the May Corporation a dividend payable in the stock of the June Corporation is to be declared. The stock of the June Corporation is recorded on the books at cost, $\$ 87,000$; market value of the stock is $\$ 100,000$.

The question is raised whether the amount to be recorded for the dividend payable should be book value or market value.

## Required:

a. Discuss the propriety of the two methods of recording the dividend liability, including in your discussion an analysis of the circumstances under which each might be acceptable.
b. The property dividend declaration might state that "corporate property is being distributed as a dividend," or it might state that "corporate property is being distributed in payment of the dividend liability." Discuss briefly the significance of the wording of the property dividend declaration and its effect upon the stockholder receiving the dividend.

## Number 4 (Estimated time-20 to 25 minutes)

The president of Woodie Corporation, your client, has asked you for an explanation of a "quasi-reorganization." He is unfamiliar with the procedure and is concerned that a competitor might have an advantage since undergoing a "quasi-reorganization."

## Required:

Prepare a report for the president explaining the "quasi-reorganization." Your report should include the following points:

1. Definition and accounting features of the procedure.
2. The purpose of the procedure. Under what conditions should it be considered?
3. Authorization necessary.
4. Disclosure required in the financial statements.
5. Does the competitor have an advantage? Discuss briefly.

## Number 5 (Estimated time- 20 to 30 minutes)

The certified public accountant is frequently called upon by management for advice regarding methods of computing depreciation. Although the question arises less frequently, of comparable importance is whether the depreciation method should be based on the consideration of the assets as units, a group or as having a composite life.

## Required:

a. Briefly describe the depreciation methods based on treating assets as: 1. Units.
2. A group or as having a composite life.
b. Present the arguments for and against the use of each of the two methods.
c. Describe how retirements are recorded under each of the two methods.

## Number 6 (Estimated time- 25 to 35 minutes)

The amortization and write-down or write-off of intangible assets involve basic accounting principles of balance sheet presentation and income determination.

## Required:

a. Give the two broad classifications or types of intangible assets and indicate the factors you would consider in classifying them.
b. State the generally accepted accounting procedures for the amortization, write-down or write-off of the two classifications of intangible assets.
c. It has been argued, on the grounds of conservatism, that all intangible assets should be written off immediately after acquisition. Give the accounting arguments against this treatment.

## Number 7 (Estimated time-30 to $\mathbf{3 5}$ minutes)

Specific identification is sometimes said to be the ideal method for assigning cost to inventory and to cost of goods sold.

## Required:

a. List the arguments for and against the above statement.
b. First-in, first-out; weighted average; and last-in, first-out methods are often used instead of specific identification. Compare each of these methods with the specific identification method. Include in your discussion an analysis of the theoretical propriety of each method in the determination of income and asset valuation. (Do not define the methods or describe their technical accounting procedures.)

## Number 8 (Estimated time- 30 to 35 minutes)

a. Present briefly the arguments for using each of the following valuation bases for reporting assets in the balance sheet:

1. Market value or realizable value.
2. Original cost, or original cost less estimated depreciation. (Do not discuss depreciation accounting.)
3. Appraised value.
b. Explain the relation of the "going concern concept" to each of the above bases of valuation.

# EXAMINATION IN ACCOUNTING PRACTICE-PART I 

November 7, 1962; 1:30 to 6:00 p.m.

## (All problems are required.)

## Number 1 (Estimated time- 35 to 45 minutes)

Blacken the appropriate space on the separate answer sheet for each of the following items. The answers should be selected in accordance with the current Internal Revenue Code and Regulations. There is only one correct answer for each question.

Statement of facts for items 1-4:
Bessie Smith, age 65, is the widow of Alan Smith, who died in 1960 at the age of 72. Mrs. Smith has never worked; however, she collects social security benefits based upon her husband's 15 years of covered earnings. She has no dependents. Her 1961 income consists of:
Dividends from domestic corporations . . . . . . . . . . . . . . . . . . . . $\$ 2,000$
Dividends from foreign corporations $\$ 400$
Less foreign income tax withheld . . . . . . . . . . . . . . . . . . . . . . . . 40
360
Interest on savings bank accounts . . . . . . . . . . . . . . . . . . . . . . . . 400
Interest on redemption of E bonds . . . . . . . . . . . . . . . . . . . . . . . . 120
Social security benefits ( 12 payments of \$60) ............ . . . . $\quad 720$
Short-term capital gains . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $\quad \mathbf{3 , 2 0 0}$

1. Total dividends to be included in adjusted gross income are:
a. $\$ 2,000$
b. $\$ 2,350$
c. $\$ 2,360$
d. $\$ 2,400$
e. None of the above.
2. Mrs. Smith's income tax is computed at the rates applicable to:
a. Single taxpayers.
b. Married taxpayers filing joint returns.
c. Married taxpayers filing individual returns.
d. Heads of household.
e. None of the above.
3. Mrs. Smith's retirement income credit is $20 \%$ of:
a. $\$ 480$
b. $\$ 1,200$
c. $\$ 6,080$
d. $\$ 6,120$
e. None of the above.
4. Because Mrs. Smith is over 65 she is entitled to:
a. Forgiveness of $20 \%$ of her income tax.
b. Unlimited medical expense deductions.
c. An additional personal exemption.
d. Exclusion of $E$ bond interest from income.
e. None of the above.

## Statements of facts for items 5-6:

Mr. Locke's security transactions for 1961 were as follows:
2/1-Purchased, $\$ 10,000$ Fair City, Illinois, $4 \%$ bonds, dated $2 / 1 / 58$, due 7/1/61, @ 101 \$10,100
5/1-Purchased, $\$ 5,000$ S.D.B. Corp. $6 \%$ bonds, dated $1 / 1 / 54$, due $3 / 1 / 66$, @ 106 plus accrued interest ...... 5,350
$7 / 1-\$ 10,000$ Fair City, Illinois, $4 \%$ bonds were redeemed $\ldots .$. . 10,000
Received interest on Fair City bonds . . . . . . . . . . . . . . . . . . . . 167
9/1—Received interest on S.D.B. Corp. 6\% bonds . . . . . . . . . . . . . 150
Where he has the right of election, Mr. Locke has decided not to amortize bond premium for income tax purposes.
5. Mr. Locke must report:
a. Long-term capital loss of $\$ 100$.
b. Short-term capital loss of $\$ 100$.
c. Short-term capital gain of $\$ 67$.
d. Long-term capital gain of $\$ 67$.
e. None of the above.
6. Mr. Locke's taxable interest income is:
a. $\$ 317$
b. $\$ 167$
c. $\$ 150$
d. $\$ 100$
e. None of the above.
7. During July 1961 Mr . Rand, an attorney, received stock with a par value of $\$ 5,000$ from Hugo Corporation as compensation. The fair market value of the stock was $\$ 2,800$ at the time he received it. On January 30, 1962 he sold it for $\$ 3,700$. His 1961 income tax return should include as ordinary income:
a. $\$ 5,000$
b. $\$ 3,700$
c. $\$ 2,800$
d. $-0-$
e. None of the above.

Statement of facts for items 8-11:
Mr. Chase is part owner of one oil lease containing one producing well. His share of 1961 transactions for the lease is as follows:

Paid: Lease acquisition . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . \$ 750
Tangible drilling costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . 3,000
Intangible drilling costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . 2,000
Operating costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 1,700
County personal property taxes . . . . . . . . . . . . . . . . . . 150
Received: Gross income, net of $\$ 550$ state production tax $\ldots .$. . 11,000

Gross income, all from 1961 oil production, represents $10 \%$ of the lease's estimated oil reserve. Depreciation is $\$ 290$ computed on a five-year life. Mr. Chase expenses all possible items.
8. Mr. Chase must capitalize:
a. Intangible drilling costs.
b. Operating costs.
c. Personal property taxes.
d. Tangible drilling costs.
e. None of the above.
9. Mr. Chase as operator may elect to:
a. Capitalize intangible drilling costs.
b. Defer depreciation.
c. Use cost depletion after the "cost basis" of the property is reduced to zero.
d. Compute the tax on his oil income at capital gains rates.
e. None of the above.
10. Cost depletion for 1961 is:
a. $\$ 290.00$
b. $\$ 300.00$
c. $\$ 75.00$
d. $\$ 850.00$
e. None of the above.
11. Percentage depletion for 1961 is:
a. $\$ 3,025.00$
b. $\$ 3,176.25$
c. $\$ 3,430.00$
d. $\$ 2,873.75$
e. None of the above.

For items 12-18 indicate whether each of the listed receipts of cash or produce by Mr. Barnes, a farmer, is:
a. Taxable as ordinary (business or nonbusiness) income.
b. Taxable as a capital gain.
c. Nontaxable income.
12. Government subsidies.
13. Proceeds of sales of crop shares received as rent.
14. Produce raised by Mr. Barnes and consumed by the Barnes family; expenses incurred in raising this produce are not claimed as a business expense.
15. Award for livestock exhibited at county fair.
16. Storm insurance proceeds for damage to growing crops.
17. Proceeds of sale of livestock culls which had been used for several years for breeding purposes.
18. Soil Conservation Act receipts.

For items 19-24 consider that Mr. Planter, a farmer, prepares his tax returns on a cash basis. Indicate whether each of the listed items is:
a. A deductible business expense.
b. A nondeductible item, not subject to depreciation.
c. A capital expenditure, subject to depreciation.
d. A deductible nonbusiness (personal) expense.
19. Cost of constructing a concrete dam for soil conservation.
20. Purchase of seedling fruit trees for orchard.
21. Market value of produce contributed to a recognized charitable organization.
22. Cost of dairy cattle purchased.
23. Veterinary fees for dairy cattle.
24. Purchase of additional farm acreage.

Indicate on your answer sheet whether each of the following items is true or false. Your grade on the true-false items will be determined by deducting your total of incorrect answers from your total of correct answers; if you omit an answer it will not affect either total.
25. Any declaration of estimated income tax required to be filed must include estimated social security tax on self-employment income.
26. Physician members of partnerships engaged in the practice of medicine are subject to the social security self-employment tax.
27. A husband and wife filing a joint federal income tax return may file a joint "Computation of Social Security Self-Employment Tax."

For items 28-35 consider whether the taxpayer may make a valid election to report the sale on the installment method.
28. On January 2, 1961 Dr. Allen sold his stamp collection for $\$ 1,500$ payable $\$ 300$ annually on June 1 from 1961 through 1965.
29. On December 1, 1960 Dr. Allen sold a lot for $\$ 1,500$. The closing took place December 10. Payment of $\$ 1,000$ was received on January 15, 1961 and the balance was received on January 15, 1962.
30. Same as 29 , except that the date of the sale and closing was January 2, 1961.
31. On December 31, 1960 Dr . Allen received a down payment of $\$ 7,000$ on the sale of his residence. The closing was held January 10, 1961 at which time he received $\$ 5,000$ and a $\$ 13,000$ mortgage for the balance of the total sales price of $\$ 25,000$. No principal payments on the mortgage are due until 1963.
32. Same as 31, except that the down payment was $\$ 1,000$ and the mortgage was $\$ 19,000$.
33. Dr. Allen sold his residence for $\$ 30,000$. At the closing on March 1, 1961 he received $\$ 8,000$ in cash and a purchase money mortgage of $\$ 22,000$. The first mortgage payment was due March 1, 1962. In accordance with his contractual right on September 1, 1961 the purchaser prepaid the first mortgage principal installment of $\$ 3,000$.
34. Mr. Baker, a dealer in appliances, sold a refrigerator for $\$ 600$ on July 1, 1961 receiving $\$ 100$ as down payment. The balance is payable in 20 monthly installments of $\$ 25$ each. Title passed to the buyer in July 1961.
35. Same as 34 , except that there is no down payment; the sale price is payable in 20 monthly installments of $\$ 30$ each.

## Number 2 (Estimated time- $\mathbf{4 0}$ to 50 minutes)

During 1961 the Juno Chemical Co. started a new division whose operation consists of processing a mineral into commercial products, A, B, C and D. Each product passes through identical processing operations. However, product $\mathbf{D}$ is classified as a second or reject and is sold at a lower price.

The following information is available regarding the Company's operations for 1961:

> Sales (including product D )
> \$24,480
> Production costs . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $\$ 49,769$
> Selling costs allocated to division \$ 1,224

|  | Products |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Total | A | B | C | D |
| Quantity (tons) |  |  |  |  |  |
| Beginning inventory | - | - | - | $\bar{\square}$ | - |
| Production | 634 | 305 | 137 | 22 | 170 |
| Sales | 285 | 132 | 83 | 10 | 60 |
| Ending inventory | 349 | 173 | 54 | 12 | 110 |
| Sales price per ton (Constant throughout the period) | - | \$100 | \$100 | \$100 | \$33 |

## Required:

a. Compute the inventory valuation at December 31, 1961 under the joint cost method of accounting at the lower of cost or market applied on an individual item basis.
b. Compute the inventory valuation at December 31, 1961 under the by-product method of accounting at the lower of cost or market on an individual item basis. The Company has elected to recognize income in the period in which the byproducts are produced. No selling costs are assigned to the by-products.

## Number 3 (Estimated time- 40 to 50 minutes)

The Braxton Printing Company is a proprietorship owned by Robert Braxton, who does not have the time to keep detailed accounting records. Mr. Braxton purchased the business on January 1, 1961. He asks you to prepare interim financial statements for the six months ended June 30, 1962, and he provides the following schedule:

|  | December 31, 1961 | June 30, 1962 |
| :---: | :---: | :---: |
| Cash | \$ 1,650 | \$ 2,039 |
| Note receivable | 0 | 600 |
| Accounts receivable | 1,300 | 1,700 |
| Inventory | 2,370 | 3,140 |
| Prepaid insurance | 315 | 264 |
| Equipment (original cost) | 8,600* | 10,200 |
| Total assets | \$14,235 | \$17,943 |
| Accounts payable | \$ 890 | \$ 1,100 |
| Accrued expenses | 55 | 100 |
| Total liabilities | \$ 945 | \$ 1,200 |

You are able to accumulate the following information:

1. The schedule for December 31, 1961 was taken from the financial statements you prepared for Mr. Braxton as of that date.
2. The cash balance of $\$ 2,039$ was taken from the bank statement. The client's check book reveals the following:

| Deposits: |  |
| :---: | :---: |
| Collections from customers | \$25,025 |
| Sale of equipment | 400 |
| Loan from bank (\$2,000, 4-month note due September 30, 1962) | 1,960 |
|  | \$27,385 |
| Withdrawals: |  |
| Payments to suppliers | \$20,221 |
| Insurance premiums | 264 |
| Employee salary | 775 |
| Payment on Mr. Braxton's estimated income tax | 300 |
| Purchase of equipment | 1,600 |
| Withdrawn by Mr. Braxton as salary | 2,400 |
| Miscellaneous expenses, including rent | 1,436 |
|  | \$26,996 |

3. A check for $\$ 450$ was received from a customer on June 30, 1962 and mailed to the bank on that day. The payment was deducted from the accounts receivable as of June 30 but not recorded in the check book or by the bank until July 2.
4. Mr. Braxton excluded from accounts receivable an account for $\$ 150$ that he says is uncollectible. He estimates that the cost of this sale was $\$ 120$.
5. The note receivable is noninterest bearing and is due on September 1. It was accepted on May 1 from a delinquent account receivable.
6. Printing equipment that was included in the original purchase price at $\$ 1,000$ was sold for $\$ 400$ on March 31 . New equipment costing $\$ 1,600$ was installed on April 1. All equipment has an estimated life of 10 years. Disregard salvage value of assets.
7. Mr. Braxton hired an assistant on April 1, 1962 at a salary of $\$ 3,200$ per year.
8. An examination of insurance policies reveals the following:

|  |  |  | Unexpired |  |
| :---: | :---: | :---: | :---: | :---: |
| Policy | Acquired | Term | Premium | December 31 |
| \#2479 | January 1, 1961 | 3 years | \$360 | \$240 |
| C2160 | June 1, 1961 | 1 year | 180 | 75 |
| 831 | April 1, 1962 | 1 year | 72 |  |
| C2380 | June 1, 1962 | 1 year | 192 |  |
|  |  |  | \$804 | \$315 |

9. The accrued expenses are miscellaneous public utility charges which you compute to be $\$ 70$ at June 30 . The $\$ 100$ item at June 30 is an extra month's rent that Mr. Braxton paid in error. He listed the item when the landlord advised him of the overpayment.

## Required: (Formal journal entries are not required.)

Prepare a worksheet showing:

1. Adjustments to the beginning balance sheet and to income and expense accounts to record the 1962 transactions.
2. The financial position of the Company at June 30, 1962.
3. The results of the Company's operations for the six months then ended on an accrual basis.

## Number 4 (Estimated time- 45 to 55 minutes)

On January 1, 1961 A and B formed a partnership. A contributed \$50,000 in cash and $B$ contributed the following property:

|  | Fair Market Value January 1, 1961 | B's Tax Basis January 1, 1961 |
| :---: | :---: | :---: |
| Municipal bonds | \$ 10,000 | \$ 10,050 |
| Stock of U. S. corporations | 12,000 | 6,400 |
| Land | 15,000 | 8,000 |
| Building | 38,000 | 40,000* |
| Accumulated depreciation |  | $(16,000)$ |
| Furniture and fixtures | 10,000 | 15,000** |
| Accumulated depreciation |  | $(3,000)$ |
| Inventory . . . . . . . . . . | 40,000 | 40,000 |
|  | \$125,000 | \$100,450 |

[^1]**Remaining life, 12 years.
Additional information:

1. There is no provision in the partnership agreement relating to contributed property.
2. A $5 \%$ mortgage of $\$ 25,000$ on the building was assumed by the partnership. The mortgage holder granted a moratorium for 1961 on the repayment of principal.
3. A is to be paid in cash an annual salary of $\$ 6,000$. The partners are to be credited with interest at $6 \%$ computed on their closing equities, before distribution of net income for the year, if such interest is not in excess of the income from operations for the year. Profits and losses are to be distributed equally.
4. Depreciation on fixed assets acquired or disposed of during the year is computed at one half the annual rate.

The pledge is payable $\$ 500$ on March 1, 1962 and $\$ 500$ on June 1, 1962. The March payment was made.
5. Worthless accounts are deductible for income taxes only when charged off. The partnership trial balance at December 31, 1961 follows:

| Cash | \$ 21,875 |  |
| :---: | :---: | :---: |
| Accounts receivable | 59,325 |  |
| Allowance for bad debts |  | \$ 800 |
| Inventories, December 31, 1961 | 62,400 |  |
| Land | 15,000 |  |
| Building | 38,000 |  |
| Accumulated depreciation-building |  | 1,583 |
| Furniture and fixtures | 22,500 |  |
| Accumulated depreciation-furniture |  | 1,125 |
| Vouchers payable |  | 12,790 |
| Mortgage payable |  | 25,000 |
| A Capital Account |  | 50,000 |
| A Drawing Account | 12,000 |  |
| B Capital Account |  | 100,000 |
| B Drawing Account | 5,000 |  |
| Sales |  | 220,000 |
| Dividends received |  | 700 |
| Interest on municipal bonds |  | 380 |
| Gain on sale of stock |  | 1,080 |
| Cost of goods sold | 120,975 |  |
| Operating expenses | 42,000 |  |
| Partner's salary | 6,000 |  |
| Contributions | 3,000 |  |
| Provision for bad debts | 1,000 |  |
| Depreciation-building | 1,583 |  |
| Depreciation-furniture and fixtures | 1,229 |  |
| Loss on sale of fixtures | 321 |  |
| Mortgage interest expense | 1.250 |  |
|  | \$413,458 | \$413,458 |

Additional data:

1. On March 1 the shares of stock which were purchased by B in 1958 were sold for $\$ 11,080$.
2. The $\$ 10,000$ municipal bonds were purchased by B on January 3, 1952 for $\$ 10,500$ and matured on December 31, 1961.
3. During the year fixtures purchased by B on January 2,1958 for $\$ 3,750$ were sold for $\$ 2,075$ and fixtures with a fifteen-year life were purchased for $\$ 15,000$.
4. Partnership withdrawals were made on September 1.

## Required:

a. Prepare a schedule computing ordinary income and other income items under federal income tax laws for partnerships.
b. Prepare a schedule showing each partner's share of taxable ordinary income.
c. Prepare a schedule computing the tax basis of each partner's interest in the partnership at December 31, 1961.

## Number 5 (Estimated time- 50 to $\mathbf{7 0}$ minutes)

Arthur Taine died in an accident on May 31, 1961. His will, dated February 28,1960 , provided that all just debts and expenses be paid and that his property be disposed of as follows:

Personal residence-devised to Bertha Taine, widow.
United States Treasury bonds and Puritan Co. stock-to be placed in trust. All income to go to Bertha Taine during her lifetime, with right of appointment upon her death.
Seneca Co. mortgage notes-bequeathed to Elaine Taine Langer, daughter. Cash-a bequest of $\$ 10,000$ to David Taine, son.
Remainder of estate-to be divided equally between the two children, Elaine Taine Langer and David Taine.

The will further provided that during the administration period Bertha Taine was to be paid $\$ 300$ a month out of estate income. Estate and inheritance taxes are to be borne by the residue. David Taine was named as executor and trustee.
An inventory of the decedent's property was prepared. The fair market value of all items as of the date of death was determined. The preliminary inventory, before the computation of any appropriate income accruals on inventory items, follows:

| Personal residence property | \$ 45,000 |
| :---: | :---: |
| Jewelry-diamond |  |
| York Life Insurance Co.-term life insurance policy on life of Arthur Taine. Beneficiary-Bertha Taine, widow | 120,000 |
| Granite Trust Co.-3\% savings bank account, Arthur Taine, in trust for Philip Langer (grandchild), interest credited January and July |  |
| 1; balance May 31, 1961 | 400 |
| Fidelity National Bank-checking account; balance May 31, 1961 | ,00 |
| 100,000 United States Treasury bonds, $3 \%, 1999$, interest payable March 1 and September 1 | 100,000 |
| $\$ 9,700$ Seneca Co. first mortgage notes, $6 \%, 1965$, interest payable May 31 and November 30 | 9,900 |
| 800 shares Puritan Co. common stock | 64,000 |
| 00 shares Meta Mfg. Co. common stock | 70,0 |

The executor opened an estate bank account to which he transferred the decedent's checking account balance. Other deposits, through July 1, 1962, were as follows:

Interest collected on bonds: \$100,000 United States Treasury

September 1, 1961 \$ 1,500
March 1, 1962 1,500
Dividends received on stock:
800 shares Puritan Co.
June 15, 1961 declared May 7, 1961 payable to holders of record May 27, 1961

800
September 15, 1961 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 800
December 15, 1961 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 1,200
March 15, 1962 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 800
June 15, 1962 . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 800
Net proceeds of June 19, 1961 sale of 700 shares Meta Mfg. Co. . 68,810

Payments were made from the estate's checking account through July 1, 1962 for the following:
Funeral expenses . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . \$ 2,000
Assessments for additional 1959 federal and state income tax
$(\$ 1,700)$ plus interest (\$110) to May 31, 1961
1,810
1961 income taxes of Arthur Taine for the period January 1, 1961
through May 31, 1961, in excess of amounts paid by the decedent
on Declarations of Estimated Tax
9,100

Federal and state estate taxes . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 58,000
Monthly payments to Bertha Taine: 13 payments of $\$ 300 \ldots . .$.
Attorney's and accountant's fees . . . . . . . . . . . . . . . . . . . . . . . . . . . 25,000

The executor waived his commission. However, he desired to receive his father's diamond ring in lieu of the $\$ 10,000$ specific legacy. All parties agreed to this in writing, and the court's approval was secured. All other specific legacies were delivered by July 15, 1961.

## Required:

Prepare a Charge and Discharge Statement as to Principal and Income, and its supporting schedules, to accompany the attorney's formal court accounting on behalf of the executor of the Estate of Arthur Taine for the period from May 31, 1961 through July 1, 1962. (Arthur Taine was not a resident of a community property state.) The following supporting schedules should be included:

1. Original Capital of Estate.
2. Gain on Disposal of Estate Assets.
3. Loss on Disposal of Estate Assets.
4. Funeral, Administration and Other Expenses.
5. Debts of Decedent Paid.
6. Legacies Paid or Delivered.
7. Assets (Corpus) on Hand, July 1, 1962.
8. Proposed Plan of Distribution of Estate Assets.
9. Income Collected.
10. Distributions of Income.

# EXAMINATION IN ACCOUNTING PRACTICE-PART II 

November 8, 1962; 1:30 to 6:00 p.m.

## GROUP I

(Solve all problems in this group.)

## Number 1 (Estimated time- 25 to 35 minutes)

The Sleepy Haven Township's adjusted trial balance for the General Fund as at the close of its fiscal year ending June 30, 1962 is shown below.

Sleepy Haven Township
CENERAL FUND TRIAL BALANCE
June 30, 1962
Cash . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . \$ \$ 1,100
Taxes receivable-current (note \#1) ................ . 8, 8,200
Allowance for uncollectible taxes-current ........... 150
Taxes receivable-delinquent .......................... . 2,500
Allowance for uncollectible taxes-delinquent ........ . 1,650
Miscellaneous accounts receivable ..................... 4,000
Allowance for uncollectible accounts . . . . . . . . . . . . . . . 5
Due from Working Capital Fund . .................... . . 5,000
Appropriation expenditures (note \#2) ............... 75,500
Encumbrances . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 3,700
Revenues (note \#3) ..................................... . . $\quad \mathbf{6 , 0 0 0}$
Due to Utility Fund . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . .
Vouchers payable . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . $\quad$ 2,000
Reserve for encumbrances-prior year . . . . . . . . . . . . . $\quad$ 4,400
Reserve for encumbrances ............................. . 3 3,700
Surplus receipts (note \#4) ............................ 700
Appropriations . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . . 72,000
Unappropriated surplus . . . . . . . . . . . . . . . . . . . . . . . . . . .
\$100,000 \$100,000
Note \#1 The current tax roll and miscellaneous accounts receivable, recorded on the accrual basis as sources of revenue, amounted to $\$ 50,000$ and $\$ 20,000$, respectively. These items have been recorded on the books subject to a $2 \%$ provision for uncollectible accounts.
Note \#2 Includes $\$ 4,250$ paid during the fiscal year in settlement of all purchase orders outstanding at the beginning of the fiscal year.
Note \#3 Represents the difference between the budgeted (estimated) revenue of $\$ 70,000$ and the actual revenue realized during the fiscal year.
Note \#4 Represents the proceeds from sale of equipment damaged by fire.

## Required:

a. Prepare in columnar form an "Analysis of Changes in Unappropriated Surplus" for the year ending June 30, 1962 with column headings: "Estimated," "Actual," and "Excess or Deficiency of Actual Compared with Estimated."
b. Prepare a formal balance sheet at June 30, 1962.

## Number 2 (Estimated time- 50 to 60 minutes)

The following were some of the account balances of the Victoria Products Company at December 30, 1960:
Reserve for contingencies ..... \$45,000
Allowance for depreciation ..... 280,000
Reserve for fire insurance ..... 21,000
Reserve for future inventory loss ..... 40,000
Reserve to reduce inventory cost to market ..... 9,000
$6 \%$ Preferred stock ( $\$ 100$ par) ..... 100,000
Premium on preferred stock ..... 20,000
Common stock ( $\$ 10 \mathrm{par}$ ) ..... 560,000
Premium on common stock ..... 64,000
Retained earnings ..... 88,684
Treasury stock-preferred ( 50 shares at cost) ..... 5,300
Treasury stock-common ( 1,000 shares at cost) ..... 10,000

The price of the Company's common stock has been advancing steadily on the market; it was $\$ 23$ at January 1, $\$ 25$ on July 1, and $\$ 30$ at the end of the year 1961. The preferred stock has a value of $\$ 105$ per share if the Company is liquidated.

The Company has adopted the following accounting policies:
a. The "clean surplus" (all-inclusive) theory is used in the preparation of the income statement.
b. Each year $\$ 7,000$ is charged to Insurance Expense with the credit going to the Reserve for Fire Insurance. Fire losses are charged to the Reserve.
c. Each year $\$ 3,000$ is debited to the Cost of Goods Sold and credited to Reserve for Future Inventory Loss; if it is necessary to reduce the carrying value of inventory to market, $60 \%$ of the reduction is charged to this Reserve account and the remainder to Cost of Goods Sold. The balance in the Reserve to Reduce Inventory Cost to Market account at December 31, 1961 is $\$ 23,000$.
d. Each year, before adjusted net income is determined, a debit or credit to Profit and Loss with an offsetting entry to Reserve for Contingencies is made. The amount is equal to $40 \%$ of the difference between unadjusted net income and \$250,000.
e. Depreciation on certain machinery is based upon units produced. Depreciation based upon production amounted to $\$ 40,000$ in 1961; depreciation computed by the straight-line method would have been $\$ 30,000$.

The following additional information is available:

1. Net loss from fire during the year was $\$ 15,000$.
2. Adjusted net income reported by the firm was $\$ 268,000$ after giving effect to "a" through "e" above.
3. The regular dividends on preferred were paid. A $\$ .25$ per share cash divi-
dend was paid on the common stock on April 1; in addition, $4 \%$ dividends in shares of common stock were paid on the common on June 30 and December 31. Treasury shares, to the extent available, were used to pay the stock dividend, and the balance came from authorized but unissued shares. The Company does not pay dividends on treasury stock.

## Required:

(Ignore income tax implications)
a. Compute the corrected net income for 1961 on the clean surplus (allinclusive income statement) theory.
b. Compute the balance in the Retained Earnings account at December 31, 1961.
c. Compute the book value per share of common stock at December 31, 1961.

## Number 3 (Estimated time- 50 to 70 minutes)

The Rocky Gravel Company mines and processes rock and gravel. It started in business on January 1, 1961 when it purchased the assets of another company. You have examined its financial statements at December 31, 1961 and have been requested to assist in planning and projecting operations for 1962. The Company also wants to know the maximum amount by which notes payable to officers can be reduced at December 31, 1962.

The adjusted trial balance follows:
The Rocky Gravel Company

## ADJUSTED TRIAL BALANCE

## December 31, 1961

| Cash | \$ 17,000 |  |
| :---: | :---: | :---: |
| Accounts receivable | 24,000 |  |
| Mining properties | 60,000 |  |
| Accumulated depletion |  | \$ 3,000 |
| Equipment | 150,000 |  |
| Accumulated depreciation |  | 10,000 |
| Organization expense | 5,000 |  |
| Accumulated amortization |  | 1,000 |
| Accounts payable |  | 12,000 |
| Federal income taxes payable |  | 22,000 |
| Notes payable to officers |  | 40,000 |
| Capital stock |  | 100,000 |
| Premium on capital stock |  | 34,000 |
| Sales |  | 300,000 |
| Production costs (including depreciation and depletion) | 184,000 |  |
| Administrative expense (including amortization and interest) | 60,000 |  |
| Provision for federal income taxes | 22,000 |  |
|  | \$522,000 | \$522,000 |

You are able to develop the following information:

1. The total yards of material sold is expected to increase $10 \%$ in 1962, and the average sales price per cubic yard will be increased from $\$ 1.50$ to $\$ 1.60$.
2. The estimated recoverable reserves of rock and gravel were $4,000,000$ cubic yards when the properties were purchased.
3. Production costs include direct labor of $\$ 110,000$ of which $\$ 10,000$ was attributed to inefficiencies in the early stages of operation. The union contract calls for $5 \%$ increases in hourly rates effective January 1, 1962. Production costs, other than depreciation, depletion and direct labor, will increase $4 \%$ in 1962.
4. Administrative expense, other than amortization and interest, will increase $\$ 8,000$ in 1962.
5. The Company has contracted for additional movable equipment costing $\$ 60,000$ to be in production on July 1, 1962. This equipment will result in a direct labor hour savings of $8 \%$ as compared with the last half of 1961. The new equipment will have a life of 20 years. All depreciation is computed on the straight line method. The old equipment will continue in use.
6. The new equipment will be financed by a $20 \%$ down payment and a $6 \%$ three-year chattel mortgage. Interest and principal payments are due semiannually on June 30 and December 31, beginning December 31, 1962. The notes payable to officers are demand notes dated January 1, 1961, on which $6 \%$ interest is provided for and was paid on December 31, 1961.
7. Accounts receivable will increase in proportion to sales. No bad debts are anticipated. Accounts payable will remain substantially the same.
8. Percentage depletion allowable on rock and gravel is to be computed at $5 \%$ of gross income and is limited to $50 \%$ of net income before depletion.
9. It is customary in the rock and gravel business not to place any value on stockpiles of processed material which are awaiting sale.
10. Assume an income tax rate of $50 \%$.
11. The Company has decided to maintain a minimum cash balance of $\$ 20,000$.
12. The client understands that the ethical considerations involved in preparing the following statements will be taken care of by your letter accompanying the statements. (Do not prepare the letter.)

## Required:

a. Prepare a statement showing the net income projection for 1962.
b. Prepare a statement which will show cash flow projection for 1962 and will indicate the amount that notes payable to officers can be reduced at December 31, 1962.

Note: Round all amounts to the nearest $\$ 100$. If the amount to be rounded is exactly $\$ 50$, round to the next highest $\$ 100$.

## Number 4 (Estimated time- 30 to 45 minutes)

The president of the Bankrola Company, F. A. Bank, is planning to retire. By agreement with the other stockholders of the Company he will exchange his capital stock and voting rights for nonvoting preferred stock.

The Bankrola Company has no preferred stock in its capitalization. The capital stock is held as follows:
100 shares held by F. A. Bank, President
350 shares held by J. R. Fenn, Executive Vice-President
150 shares held by M. A. Rola, Vice-President in Charge of Sales
$\frac{150}{\underline{750}}$ shares held in treasury of Company
$\underline{\underline{l}}$ shares, total capital stock issued

The stockholders' equity section of the Company's balance sheet follows:

| Capital stock (\$100 par value) | \$ 75,000 |
| :---: | :---: |
| Premium on stock | 37,500 |
| Retained earnings | 17,500 |
| Total | 130,000 |
| Treasury stock, at cost | 10.000 |
| Total stockholders' equity | \$120.000 |

Under the terms of the agreement the Company will be reorganized as follows:

1. The treasury stock will be canceled.
2. Two new stock issues will be authorized, common and $5 \%$ cumulative nonvoting preferred. Both will be $\$ 100$ par value per share.
3. The stockholders will surrender their capital stock for cancellation and will receive the newly authorized issues as follows:
a. F. A. Bank will receive only preferred stock.
b. J. R. Fenn will receive $60 \%$ of the common stock and the remainder of of the preferred.
c. M. A. Rola will receive $40 \%$ of the common stock.
4. The combined total number of shares of common and preferred stock outstanding after the exchange will be the same as the total number of shares authorized and outstanding before the transfer (after giving effect to the retirement of the treasury stock).

## Required:

a. Prepare the journal entry to cancel the treasury stock account on the books of the Company.
b. Prepare a schedule computing the amount of each stockholder's equity in the Company before the recapitalization.
c. Compute the number of new common stock and new preferred stock shares to be issued.
d. Prepare a schedule computing the number of shares of each type of newly issued stock that each stockholder must receive so that he will have the same equity in the Company after the exchange as before the exchange.

## GROUP II

## (Estimated time- $\mathbf{4 0}$ to 60 minutes)

> (Solve only one of the two problems in this group. If both are solved, only the first will be considered.)

## Number 5

To obtain a more realistic appraisal of his investment Martin Arnett, your client, has asked you to adjust certain financial data of The Glo-Bright Company for price level changes. On January 1, 1959 he invested $\$ 50,000$ in The Glo-Bright Company in return for 10,000 shares of common stock. Immediately after his investment the trial balance appeared as follows:

|  | Dr. | Cr. |
| :---: | :---: | :---: |
| Cash and receivables | \$ 65,200 |  |
| Merchandise inventory | 4,000 |  |
| Building | 50,000 |  |
| Accumulated depreciation-building |  | \$ 8,000 |
| Equipment | 36,000 |  |
| Accumulated depreciation-equipment |  | 7,200 |
| Land | 10,000 |  |
| Current liabilities |  | 50,000 |
| Capital stock, \$5 par |  | 100,000 |
|  | \$165,200 | \$165,200 |

Balances in certain selected accounts as of December $3 \overline{\overline{1} \text { of each of the next }}$ three years were as follows:


Assume the 1959 price level as the base year and that all changes in the price level take place at the beginning of each year. Further assume that the 1960 price level is $10 \%$ above the 1959 price level and that the 1961 price level is $10 \%$ above the 1960 level.

The building was constructed in 1955 at a cost of $\$ 50,000$ with an estimated life of 25 years. The price level at that time was $80 \%$ of the 1959 price level.

The equipment was purchased in 1957 at a cost of $\$ 36,000$ with an estimated life of ten years. The price level at that time was $90 \%$ of the 1959 price level.

The LIFO method of inventory valuation is used. The original inventory was acquired in the same year the building was constructed and was maintained at a constant $\$ 4,000$ until 1959. In 1959 a gradual buildup of the inventory was begun in anticipation of an increase in the volume of business.

Arnett considers the return on his investment as the dividend he actually receives. In 1961 Glo-Bright paid cash dividends in the amount of $\$ 8,000$.

On July 1, 1960 there was a reverse stock split-up of the Company's stock in the ratio of one-for-ten.

## Required:

a. Compute the 1961 earnings per share of common stock in terms of 1959 dollars.
b. Compute the percentage return on investment for 1959 and 1961 in terms of 1959 dollars.

## Number 6

Grana Corporation's trial balance at December 31, 1961 includes the following accounts:

| Current assets | \$248,000 |  |
| :---: | :---: | :---: |
| Machinery and equipment, at cost | 86,000 |  |
| Accumulated depreciation of machinery and equipment |  | \$ 52,000 |
| Office fixtures, at cost | 20,000 |  |
| Accumulated depreciation of office fixtures |  | 21,700 |
| Other fixed assets | 17,000 |  |
| Patent, at cost | 39,000 |  |
| Accumulated amortization of patent |  | 14,000 |
| Current liabilities |  | 79,000 |
| Sales |  | 337,000 |
| Cost of goods sold, including depreciation of \$14,000 | 215,000 |  |
| Selling expenses | 27,000 |  |
| General expenses, including depreciation on office fixtures of $\$ 2,700$ | 19,000 |  |

The capital stock account at January 1, 1961 was $\$ 70,000$. Additional stock was issued on March 1, 1961 for $\$ 15,000$.

During your audit you determine that

1. The patent became worthless on January 2, 1961. No amortization was recorded in 1961.
2. Depreciation of machinery and equipment for tax purposes is $\$ 26,000$ under an accelerated method.
3. Office fixtures were overdepreciated for book purposes in 1961. They have been completely depreciated for tax purposes since 1959.
4. Current assets include short term municipal bonds at the total purchase price and accrued interest of $\$ 100$ paid at the time of purchase. The first interest coupon, for $\$ 500$, is dated January 1, 1962 and has not been accrued on the books.
5. General expenses include a payment to the Internal Revenue Service of $\$ 11,800$, consisting of an additional assessment for 1960 tax $(\$ 11,300)$ and interest to date of payment.
6. Under the terms of his contract dated January 1, 1961, Mr. Able, the Corporation's president, is to receive a bonus of $20 \%$ of corporate net income after provision for federal income taxes and bonuses. Such corporate net income is to be determined in accordance with generally accepted accounting principles except that allocation of federal income taxes for differences between book and income tax net income should be ignored.
7. Mr. Baker, the sales manager, is to receive a bonus equal to $50 \%$ of Mr . Able's bonus.
8. Under the terms of a loan agreement the combined bonuses may not exceed $25 \%$ of average paid-in capital.

## Required:

a. Prepare a schedule showing the computation of Grana Corporation's net income before bonuses and income taxes in accordance with generally accepted accounting principles.
b. Prepare a schedule showing the computation of Grana Corporation's taxable income before bonuses.
c. Compute the limitation on the bonuses.
d. Without prejudice as to the correctness of your answers under requirements " $a$ " and " $b$," assume that computations under requirement " $a$ " above show net income of $\$ 100,000$ and under requirement " $b$ " above show taxable income of $\$ 70,000$. Compute the bonuses payable to Able and Baker, and the income taxes payable. Use a tax rate of $50 \%$.

# EXAMINATION IN AUDITING 

November 8, 1962; 8:30 a.m. to 12:00 m.

## Number 1 (Estimated time-20 to 25 minutes)

You are auditing the Alaska Branch of Far Distributing Co. This branch has substantial annual sales which are billed and collected locally. As a part of your audit you find that the procedures for handling cash receipts are as follows:

Cash collections on over-the-counter sales and C.O.D. sales are received from the customer or delivery service by the cashier. Upon receipt of cash the cashier stamps the sales ticket "paid" and files a copy for future reference. The only record of C.O.D. sales is a copy of the sales ticket which is given to the cashier to hold until the cash is received from the delivery service.

Mail is opened by the secretary to the credit manager and remittances are given to the credit manager for his review. The credit manager then places the remittances in a tray on the cashier's desk. At the daily deposit cut-off time the cashier delivers the checks and cash on hand to the assistant credit manager who prepares remittance lists and makes up the bank deposit which he also takes to the bank. The assistant credit manager also posts remittances to the accounts receivable ledger cards and verifies the cash discount allowable.

You also ascertain that the credit manager obtains approval from the executive office of Far Distributing Co., located in Chicago, to write off uncollectible accounts, and that he has retained in his custody as of the end of the fiscal year some remittances that were received on various days during the last month.

## Required:

a. Describe the irregularities that might occur under the procedures now in effect for handling cash collections and remittances.
b. Give procedures that you would recommend to strengthen internal control over cash collections and remittances.

## Number 2 (Estimated time- 15 to 20 minutes)

In a preliminary discussion, prior to beginning your audit of the Mark Company, the president states that he would like to ascertain whether any key employees have interests which conflict with their duties at the Mark Company. He asks that, during your regular audit, you be watchful for signs of these conditions and report them to him.

## Required:

Briefly discuss your professional position in this matter. Include the following aspects in your discussion:
a. The responsibility of the CPA for the discovery of conflicts of interest. Give reasons for your position.
b. The advisability of requesting that the client's letter of representation contain a statement that no conflict of interests is known to exist among the Company's officers and employees. What action, if any, would you take if the client refused to sign the letter? How would his refusal affect your opinion?
c. At the same time that you are conducting the audit of Mark Company you are also conducting the audit of Timzin Company, a supplier of Mark Company. During your audit of Timzin Company you determine that an employee of Mark Company is receiving "kickbacks."

1. Discuss your responsibility, if any, to reveal this practice to the president of Mark Company.
2. Discuss your professional relationship with Timzin Company after discovering the "kickbacks."

## Number 3 (Estimated time- 20 to 25 minutes)

You are engaged in the audit of the financial statements of the Sandy Core Company for the year ended December 31, 1961. Sandy Core Company sells lumber and building supplies at wholesale and retail; it has total assets of $\$ 1,000,000$ and a stockholders' equity of $\$ 500,000$.

The Company's records show an investment of $\$ 100,000$ for 100 shares of common stock of one of its customers, the Home Building Corporation. You learn that Home Building Corporation is closely held and that its capital stock, consisting of 1,000 shares of issued and outstanding common stock, has no published or quoted market value.

Examination of your client's cash disbursements record reveals an entry of a check for $\$ 100,000$ drawn on January 23, 1961 to Mr. Felix Wolfe, who is said to be the former holder of the 100 shares of stock. Mr. Wolfe is president of the Sandy Core Company. Sandy Core Company has no other investments.

## Required:

a. List the auditing procedures you would employ in connection with the
$\$ 100,000$ investment of your client in the capital stock of the Home Building Corporation.
b. Discuss the presentation of the investment on the balance sheet, including its valuation.

## Number 4 (Estimated time- 20 to 25 minutes)

In his examination of financial statements the CPA is concerned with the examination and accumulation of accounting evidence.

## Required:

a. What is the objective of the CPA's examination and accumulation of accounting evidence during the course of his audit?
b. The source of the accounting evidence is of primary importance in the CPA's evaluation of its quality. Accounting evidence may be classified according to source. For example, one class originates within the client's organization, passes through the hands of third parties, and returns to the client, where it may be examined by the auditor. List the classifications of accounting evidence according to source, briefly discussing the effect of the source on the reliability of the evidence.
c. In evaluating the quality of the accounting evidence the CPA also considers factors other than the sources of the evidence. Briefly discuss these other factors.

## Number 5 (Estimated time-25 to 35 minutes)

Internal auditing is a staff function found in virtually every large corporation. The internal audit function is also performed in many smaller companies as a part-time activity of individuals who may or may not be called internal auditors. The differences between the audits by independent public accountants and the work of internal auditors are more basic than is generally recognized.

## Required:

a. Briefly discuss the auditing work performed by the independent public accountant and the internal auditor with regard to:

1. Auditing objectives.
2. General nature of auditing work.
b. In conducting his audit the independent public accountant must evaluate the work of the internal auditor. Discuss briefly the reason for this evaluation.
c. List the auditing procedures used by an independent public accountant in evaluating the work of the internal auditor.

## Number 6 (Estimated time- 25 to 35 minutes)

Part a. You have been approached by promoters to give an opinion on the financial statements to be included in the prospectus of a proposed corporation to be named Easy Park Corporation.

Easy Park Corporation will own and operate a downtown parking garage and plans to purchase parking lots. The promoters now own and operate a parking garage which they acquired three months ago for $\$ 100,000$. At the time of acquisition an independent expert appraiser placed a value of $\$ 300,000$ on the property. There has been no change in the values of downtown properties in recent months. The property is mortgaged for $\$ 50,000$ at the present time.

The new corporation will have an authorized capital of 50,000 shares with a par value of $\$ 10.00$ per share. The promoters will receive 25,000 shares of stock in exchange for the parking garage which Easy Park Corporation will acquire subject to the existing mortgage of $\$ 50,000$. There will be a public offering of the remaining 25,000 shares at $\$ 9.00$ per share. The public sale will not be subject to SEC approval because the sale will be restricted to the residents of one state.

It is the intention of the promoters to have the prospectus balance sheet show a value of $\$ 300,000$ for the parking garage and a net worth of $\$ 250,000$.

## Required:

Would it be proper to allow your name to be used in connection with this proposed balance sheet if full disclosure is made in a footnote to the balance sheet? Discuss fully.

Part b. The processing operations of Gaylord Co., your client, require a basic raw material, colgum, which is imported and refined by several domestic suppliers. Colgum is combined with other raw materials of the same general category to produce the finished product. Gaylord Co. has been disturbed by the unreliability of the supply because of the international situation and labor troubles of the suppliers and has stockpiled a large supply of colgum to assure continued operations. This supply of colgum is a substantial portion of Gaylord's inventory and you determine that it is a three year supply. Colgum is a staple commodity widely used in manufacturing operations. Gaylord has consistently applied the "lower of cost or market" rule to the valuation of its total inventory. The year-end market price of colgum is less than Gaylord's cost.

## Required:

1. What effect, if any, would this excess supply have upon the financial statements and your report? Discuss briefly.
2. What effect, if any, would this excess supply have upon the application of the rule of "cost or market, whichever is lower" to the valuation of individual items as against category totals in the total inventory? Discuss briefly.

## Number 7 (Estimated time- $\mathbf{4 0}$ to 45 minutes)

During your audit of the financial statements of The Newbold Corporation for the year ended December 31, 1961 you determine that the Company's surplus funds have been temporarily invested in securities. The Company's books are maintained on the accrual basis. A transcript of the Investments account is presented following:

## The Newbold Corporation

## WORKSHEET TO ADJUST THE INVESTMENTS ACCOUNT

December 31, 1961
Date
1961

Jan. 3 Purchased 100 shares, National Motors
5 Purchased 100 shares, Major Electronics

Mar. 1 Purchased \$6,000 City of St. Louis bonds
31 Cash dividend, National Motors

Apr. 5 Sold 100 shares, National Motors
6 Purchased 100 shares, Ace Investment
6 Purchased 100 shares, General Utility

May 1 Received 100 stock rights, General Utility

July 2 Purchased 10 shares, General Utility
15 Purchased 50 shares, Acme Laboratories
18 Purchased 20 shares, The Newbold Corporation

Aug. 15 Sold 10 shares, The Newbold Corporation

Sept. 1 Interest, City of St. Louis bonds
CR
90
1 Purchased \$10,000 U.S. Treasury bonds

Dec. 8 Received 2 shares, Acme Laboratories
J 80
8 Cash dividend, Acme Laboratories
CR20

15 Cash dividend, Ace Investment

CR ..... 90

31 Interest, U.S. Treasury bonds
31 Cash dividend, General Utility

| Account per Books |  |  |
| :---: | :---: | :---: |
| Fol | Debit | $\underline{\text { Credit }}$ |
| CD | \$ 4,500 |  |
| CD | 500 |  |

CD 6,060
CR

CR $\quad 4,800$
CD 2,300
CD 2,400

J $\quad 100$

CD 130
CD 1,900
CD 3,000

CR $\quad 1,550$

| CR |  | 90 |
| :--- | :--- | :--- |
| CD | 10,067 |  |

Balance per books

CR 200
J

| 120 |  |
| :---: | :---: |
| 31,157 | 6,800 |
|  | 24,357 |
| \$31,157 | \$31,157 |

The following information and data were developed from your audit procedures:

1. The City of St. Louis bonds were purchased as a new issue. No accrued interest was purchased.
2. The 100 General Utility rights were recorded at the May 1 quoted price on the stock exchange. (The credit of the journal entry was to Miscellaneous Income.) The stock was quoted at $\$ 19$ per share ex-rights on May 1. For each 5 rights held, one share of General Utility stock could be purchased at $\$ 13$ per share. The Company exercised rights to buy 10 shares on July 2 when the market price was $\$ 16$ per share. The rights expired on August 15.
3. The Newbold Corporation purchased 20 shares of its own stock from the estate of a deceased stockholder. The stock has a par value of $\$ 100$ and was originally issued for $\$ 115$ per share. Ten of the twenty shares were sold to an officer of the Company for $\$ 155$ per share.
4. In August Major Electronics was reorganized. The original issue of stock was eliminated. New common stock was issued to bondholders and other creditors.
5. The purchase price of the U. S. Treasury bonds included accrued interest of $\$ 67$.
6. During December Acme Laboratories declared a $5 \%$ stock dividend. In lieu of fractional shares cash was distributed based on the current market price of $\$ 40$ per share. (The credit of the journal entry was to Miscellaneous Income.)
7. The Ace Investment Co. letter accompanying its annual dividend check gave the following composition of the dividend:
$\$ .80$ Derived from income from investments
. 10 Return of stockholders' capital
$\$ .90$ Total dividend.
8. On December 15 General Utility declared a cash dividend of $\$ 1$ per share payable on January 15, 1962 to stockholders of record of December 29, 1961. (The credit of the journal entry was to Miscellaneous Income.)
9. The securities are kept in a safe deposit box. You examined the securities on January 8, 1962 after determining from the bank's records that the last entry to the box was on December 8. All securities were examined and properly accounted for.

## Required:

Prepare a worksheet showing the adjustments to arrive at the corrected balance in the Investments account at December 31, 1961, and other adjustments or reclassifications arising from your audit of the account. Your worksheet should include the names of the other accounts affected by the adjustments or reclassifications. (Formal journal entries are not required.) The books have not been closed.

# EXAMINATION IN COMMERCIAL LAW 

November 9, 1962; 8:30 a.m. to 12:00 m.

## GROUP I

(Answer all questions in this group.)

## Number 1 (Estimated time- 20 to 30 minutes)

## Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether each of the legal conclusions is true or false according to the general principles of law and provisions of the Uniform Partnership Act and the Uniform Limited Partnership Act. Write on your answer sheet whether each conclusion is true or false. Your grade will be determined by deducting your total of incorrect answers from your total of correct answers; if you omit an answer it will not affect either total.

An example of the manner in which the questions should be answered is shown in the following illustration:

## Question

Answer
XX. The right of subrogation may arise under

1. Life insurance policies.
2. Fire insurance policies.
3. Marine insurance policies.
4. Automobile collision insurance policies.
5. Health insurance policies.


## Questions to Be Answered

A. The distinctive features of the general partnership are, among others.

1. The fiduciary relationship among the partners.
2. The recognition of the partnership as an entity for all purposes.
3. The creation of the partnership by the filing of the partnership agreement and payment of a fee at the appropriate state office.
4. The mutual agency of the partners.
5. The restricted number of activities for which this form of entity can be used.
B. In comparing the corporation and the partnership it should be noted that
6. The partnership has a greater continuity of existence.
7. Bankruptcy of a general partner or a majority stockholder will cause a dissolution of the entity in question.
8. In a partnership each general partner can limit his liability to creditors for partnership debts to the extent of his capital contribution by so providing in the partnership agreement, which makes the partnership similar to the corporation in this respect.
9. Partners may be liable for the wrongful acts of individual partners, and stockholders also have similar liability for the acts of individual shareholders.
10. Whereas a corporation may be formed for charitable purposes, a partnership may not.
C. The business trust is distinguishable from the general partnership in that
11. In the trust there is a split of the legal and equitable title to property whereas in the partnership such is not the case.
12. The trust offers limited liability to the beneficiaries if the trustees are free from control by the beneficiaries whereas general partners have unlimited liability.
13. The trust is generally a more cumbersome device than the partnership for carrying on a business.
14. The beneficiaries' interests in the trust are represented by transferable certificates of ownership whereas the partners' interests are not.
15. The business trust requires government approval for its creation whereas the general partnership is created solely by agreement among the partners.
D. Trading and nontrading partnerships are
16. Distinguishable on the basis of the trading partnership carrying on a business of buying and selling for profit whereas a nontrading partnership does not buy and sell for profit.
17. Similar insofar as the apparent authority of the partners to execute negotiable instruments is concerned.
18. Different insofar as the apparent authority of the partners to borrow money is concerned.
19. Similar insofar as the fiduciary relationship of partners to each other is concerned.
20. Different insofar as the extent of personal liability is concerned.

## E. Partnership agreements

21. Must be in writing to be enforceable.
22. Must be in writing to be enforceable if the duration of the partnership is greater than a year.
23. Must be in writing to be enforceable if the partnership is going to engage in the real estate business.
24. Are a type of surety contract and, therefore, must be in writing to be enforceable.
25. Require the same formalities as to execution as a deed of real property in order to be enforceable.

## F. The partnership name

26. Must contain the name of at least one of the general partners.
27. Must not be so similar to another partnership as to deceive the public.
28. Must be registered with the Secretary of State in every state where the partnership does business.
29. Is an asset which must be accounted for upon dissolution.
30. May contain the name of a former partner.
G. Specific property belonging to the partnership
31. May be held in the partnership name.
32. May be held in an individual partner's name.
33. Is jointly owned by the partners in a tenancy in partnership.
34. May generally be attached by the individual creditors of the partners.
35. Is subject to a spouse's dower interest.
H. A partner's interest in the partnership
36. Is freely assignable.
37. Includes the right to share in the profits and the ultimate distribution upon dissolution.
38. Does not include the right to use particular partnership property.
39. Is subject to attachment by an individual partner's creditors.
40. If sold to a third party, entitles the third party to participate in the management of the partnership.
I. Upon the death of an individual partner
41. Specific partnership property vests in the surviving partner or partners.
42. The widow of the decedent has no rights insofar as specific partnership property is concerned.
43. His estate is freed from all partnership liability.
44. The executor is substituted for the deceased partner insofar as management of the partnership affairs is concerned.
45. The use of the partnership name by the partnership continuing the business does not of itself subject the deceased partner's individual property to liability for any debts contracted by such partnership.
J. Able, Baker and Charles form a partnership; if there is no contrary agreement,
46. Losses are shared in the same manner as profits.
47. Profits are shared according to the capital contributions.
48. A majority vote is necessary in order to resolve ordinary partnership matters.
49. All partners have equal rights to manage the partnership business.
50. No interest is paid on capital contributions.
K. If the facts are the same as in J above,
51. Partners are entitled to reasonable salary payments.
52. No party can become a partner without the consent of all partners.
53. Partners are entitled to interest on loans to the partnership.
54. Partners are entitled to reimbursement for expenses incurred in the ordinary course of business.
55. Partners may engage in other activities, including activities which compete with the partnership business.
L. An incoming partner
56. Does not have unlimited liability for prior debts.
57. May be required to assume a withdrawing partner's share of liability; if he does so, the withdrawing partner is free from all liability to creditors.
58. Must make a capital contribution equal to the amount of the withdrawing partner's share.
59. Is liable for prior debts to the extent of his capital contribution.
60. Has unlimited liability as to debts incurred after his entry into the partnership.
M. The Uniform Partnership Act rules for distribution of assets after dissolution
61. Insofar as they pertain to accounts between partners, may be varied by agreement.
62. Provide that the partners' capital contributions are to be repaid ahead of all other liabilities.
63. Provide that partners who are also creditors are treated the same as outside creditors with respect to priority of payment.
64. Provide that profits remaining after all other liabilities are satisfied will be distributed in accordance with the capital contribution ratios.
65. Provide that partners who make advances beyond capital contributions are repaid such advances ahead of capital contributions.
N. The Uniform Limited Partnership Act rules for distribution
66. Are the same as those of the Uniform Partnership Act.
67. Treat the limited partner who is also a creditor of the partnership as being entitled to the same priority as an outside creditor with respect to money loaned to the partnership.
68. Provide for the payment of all liabilities for debts, capital and profits owed to limited partners before any distribution is made to general partners.
69. As to each class of partners, provide for distribution of profits before distribution of capital contributions.
70. Make the capital contributions of the limited partners subject to claims of partnership creditors.
O. The "marshalling of assets" doctrine
71. Relates to the United States Marshal's seizing of partnership assets.
72. Will apply when the creditors of the partnership and the partners are asserting conflicting claims as to how assets should be applied to satisfy debts.
73. Gives preference to partnership creditors in the distribution of the firm assets.
74. Provides that any residue of partnership assets remaining after satisfaction of firm creditors will be used to satisfy individual creditors.
75. Has been expressly overruled by the Uniform Partnership Act.

## Number 2 (Estimated time- 20 to 30 minutes)

## Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether each of the legal conclusions is true or false according to the general principles of agency law. Write on your answer sheet whether each conclusion is true or false. Your grade will be determined by deducting your total of incorrect answers from your total of correct answers; if you omit an answer it will not affect either total.

## Questions to Be Answered

A. The following people may legally act as your agent when properly appointed: 76. Your husband.
77. Your wife.
78. Your minor son, age sixteen.
79. Your lawyer.
80. A stranger in the event of an emergency situation.
B. In an auction
81. The auctioneer makes the initial offer.
82. The auctioneer is initially the agent for the buyer.
83. The auctioneer subsequently becomes the agent for both parties.
84. Acceptance is manifested by the fall of the gavel.
85. The auctioneer has the status of a special agent.
C. The following are exceptions to the general rule that an agency relationship may be created orally:
86. The creation of an irrevocable agency.
87. The creation of an agency for the sale of land in some states.
88. The creation of an agency with a duration which does not exceed one year from the time the relationship was agreed upon.
89. The appointment of an exclusive agent.
90. The creation of an agency coupled with a liability.
D. A factor is a type of agent who
91. Is employed to sell the principal's goods.
92. Is compensated by a factorage or commission.
93. Usually has title to the goods he sells.
94. Can defeat the principal's rights to the goods if he sells the goods to a bona fide purchaser.
95. Has an irrevocable agency coupled with an interest.
E. A del credere agency
96. Is an example of an irrevocable agency coupled with an interest.
97. Is a surety relationship and therefore the agent's undertaking must be in writing.
98. Is usually implied if the parties are silent on the point.
99. Is by definition also an exclusive sales agency.
100. Is beneficial to the principal in that, if there is a default by the purchaser, the principal can immediately sue the agent.
F. Agency by ratification
101. Is only applicable to a situation where an agent who has been expressly appointed exceeds his authority.
102. Cannot relate to a tortious action.
103. Is the method whereby a corporation subsequently becomes bound upon the contracts made by its promoters prior to its inception.
104. Will not be effective as to a particular contract if the ratification is made after there has been a withdrawal from the agreement by the third party.
105. Requires that the acts must have been done in the name and on behalf of the person who ratifies it.
G. In order to create an agency by estoppel
106. There must be a written or oral express appointment of the agent by the principal.
107. The third party must show that he relied upon a misrepresentation of the fact of existence of the agency.
108. It must be shown that it will be to the detriment of the third party to permit the principal to deny the existence of the agency.
109. The reliance by the third party must be justified, i.e., reasonable.
110. The misrepresentation as to the existence of the agency must have been made by the principal or with his consent.
H. The agent owes a duty to the principal to
111. Represent only his principal and not to deal for himself.
112. Refuse to represent other principals whose interests conflict with the principal's interest.
113. Exercise extreme or great care in carrying out his agency responsibilities.
114. Obey the instructions and orders of his principal.
115. Render an accounting if the principal so demands.
I. An agent will have personal liability
116. For contracts he makes as an agent for a nonexistent principal.
117. If he signs a negotiable promissory note in his own name.
118. If he misrepresents and makes a contract outside of the scope of his authority.
119. If he commingles funds, even though he was acting in good faith and was not negligent.
120. For all torts he commits even if committed within the scope of his authority.
J. The following factors will cause a termination of the agency relationship by operation of law:
121. Bankruptcy of the agent.
122. Disloyalty of the agent.
123. An adjudication of insanity of the principal.
124. Subsequent legislation which makes the performance of the agent's duties illegal.
125. The commission of a tort by the agent within the scope of his authority.
K. The authorization to manage a business includes the authority
126. To bind the principal on surety contracts.
127. To make contracts which are reasonably necessary to the conduct of the business.
128. To employ, supervise, or discharge employees as the course of business may reasonably require.
129. To delegate his duties as manager to another person of equal competence.
130. To make extraordinary repairs of the existing buildings.
L. An undisclosed principal
131. Is immediately bound on any contract made by his agent which is within the agent's express authority.
132. Will be bound on a contract outside the agent's scope of authority if he ratifies the contract.
133. Cannot enforce the contract unless he accepts it prior to the receipt of a revocation by the third party.
134. Cannot personally sue on the contract but must do so in the name of the agent.
135. May not enforce the contract in the majority of jurisdictions because it is against public policy to permit him to do so.
M. The undisclosed principal is not bound to the third party by a contract which 136. Specifically excludes him.
137. Is a negotiable or nonnegotiable instrument.
138. Is a sealed instrument unless a statute has been passed to the contrary.
139. The third party, aware of the principal's existence, elects to enforce against the agent.
140. Is required to be in writing and signed, and is signed by the agent.
N. An agent's authority may be expanded by
141. An ambiguous statement of his express authority by the principal.
142. Implication from the express authority.
143. A finding that the particular action taken is customary as to this type of agent.
144. An emergency.
145. Statements relating to the agent's authority made by third parties with the principal's consent.
O. When an agent has violated his duties, the principal is entitled to
146. An accounting.
147. Discharge the agent.
148. An order by the court compelling the agent to perform his duties properly.
149. Sue for breach of the contract of service.
150. A possessory lien on the principal's money or property in the agent's hands.

## Number 3 (Estimated time- 20 to 30 minutes)

## Instructions

Each of the following numbered phrases or clauses states a legal conclusion as it completes the related lettered material. You are to determine whether each of the legal conclusions is true or false according to the general principles of lien and trust law. Write on your answer sheet whether each conclusion is true or false. Your grade will be determined by deducting your total of incorrect answers from your total of correct answers; if you omit an answer it will not affect either total.

## Questions to Be Answered

A. A pledge is a common type of
151. Bailment.
152. Security device.
153. Contractual relationship which must be in writing to be valid.
154. Transfer of title to personal property.
155. Conveyance of real property.
B. In order to perfect a pledge a pledgee must
156. File a copy of the contract creating the pledge.
157. Give written notice to other creditors of the pledgor.
158. Obtain possession of the property.
159. Insure the property against loss.
160. Owe a debt or the performance of some obligation to the pledgor.
C. The following situations will give rise to a pledge:
161. Taking possession of abandoned property.
162. Placing securities in your safe deposit box.
163. Parking your car in a parking lot but retaining the keys.
164. Hanging your coat on a rack in a restaurant.
165. Pawning a Phi Beta Kappa key.
D. In the absence of an agreement to the contrary, a pledgee
166. Has a pledge interest in any profits that accrue.
167. Has a pledge interest in any increase in the pledged property.
168. Has the absolute right to the profits as an additional part of his fee.
169. Has the absolute right to any increase in the pledged property as an additional part of his fee.
170. Is entitled to reimbursement for necessary expenses arising from the pledge.
E. The pledgee has a duty to
171. Use the pledged property only as authorized.
172. Exercise slight care of the property.
173. Refrain from wilfully harming the pledged property.
174. Insure the property for the pledgor's benefit.
175. Return identical property in all circumstances.
F. The following may be the subject matter of a pledge:
176. Inventory.
177. Negotiable instruments.
178. Documents of title.
179. Real property.
180. Intangible personal property.
G. A valid tender of payment by the pledgor
181. Terminates the pledge.
182. Releases the pledgor from the underlying debt.
183. Entitles the pledgor to possession of the pledged property.
184. Will permit the pledgor to sue for conversion if the pledgee refuses to return the property.
185. Automatically changes the pledgee's lien from a possessory to a charging lien.
H. In the absence of any agreement between the parties the pledgee, upon default by the pledgor,
186. Takes absolute title to the property.
187. May sell the property and retain all of the proceeds, even though they are in excess of the amount due.
188. May sell the property and hold the pledgor for a deficiency resulting from a bona fide sale.
189. Must proceed pursuant to a judicial foreclosure in order to cut off the pledgor's interest.
190. Will lose his right to sell the property if the pledgor dies before the sale is made.
I. When property has been pledged,
191. The pledgee has an insurable interest in the pledged property.
192. The pledgor has an insurable interest in the pledged property.
193. The pledgee can sue a third person for conversion of the pledged property.
194. The pledgor retains title to the property.
195. The pledgee can sell his interest in the pledged property.
J. The following are common methods of creating a pledge:
196. A physical delivery of the property to the pledgee.
197. A physical delivery of a document of title representing the goods to the pledgee.
198. Field warehousing.
199. Trading on margin in stocks listed on the New York Stock Exchange.
200. A transfer of title to the pledgee.
K. The sole trustee of a private express trust
201. Can also be the sole beneficiary of the trust.
202. Has a fiduciary duty to the beneficiaries of the trust.
203. Can be the person who created the trust, naming himself as trustee.
204. Has legal title to the subject matter of the trust.
205. Must have legal capacity to own the property in question.
L. The following statements apply to a charitable trust:
206. It can only be created by a writing.
207. The duration may be perpetual.
208. The beneficiaries may be infinite in number and unascertainable.
209. The trust may be saved by carrying out the intention of the settlor as nearly as possible.
210. An essential element is that it have for its object some public benevolence.
M. A trust will terminate as a result of
211. Death or incompetency of the trustee.
212. Resignation by the trustee.
213. The expiration of the period of time designated in the trust agreement.
214. Agreement by all the beneficiaries to terminate the trust and distribute the property.
215. The vesting of the legal and equitable interests under the trust in the same person.
N. In order to create a valid inter vivos trust
216. There must be a written instrument creating the trust.
217. The settlor, i.e., party creating the trust, must have the legal capacity to make the transfer.
218. The beneficiary must have knowledge of the creation of the trust.
219. The beneficiary must have the general capacity to contract.
220. The donor's disposition must be irrevocable.
O. A constructive trust
221. Arises by operation of law.
222. Must be in writing to be valid.
223. Will be created regardless of the intention of the parties.
224. Is often imposed when there has been a breach of the fiduciary duty.
225. Has as its basis fraud, actual or constructive.

## Number 4 (Estimated time- 15 to 20 minutes)

Able obtained a check, drawn on City Bank, for $\$ 1,500$ from Baker by a fraudulent scheme involving the sale of bogus oil stock. He immediately negotiated it to Carl by a blank indorsement. Carl met the requirements for holding in due course. Carl then deposited it in the National Bank after indorsing it as follows: "Without recourse to me, Carl." The balance in his account after depositing this and other checks was $\$ 6,000$. The next day he deposited some additional checks totaling $\$ 7,000$ and he drew one check for $\$ 10,000$ which he gave to his broker in payment of some bonds he had purchased. This check for $\$ 10,000$ was paid by the National Bank.

Upon discovering the fraud Baker notified the City Bank to stop payment on the check. City Bank stopped payment as requested and returned the check to National Bank. National Bank then demanded payment from Baker. Baker refused. He claimed that the National Bank was not a holder in due course because it took the check with a "without recourse" indorsement and, therefore, should have been on notice of some defect; i.e., he claims that the check was not taken in
good faith. He also claimed that National had not given value since the bank had $\$ 3,000$ of Carl's money on deposit, an amount which was sufficient to cover the check.

## Required:

a. 1. Can the National Bank qualify as a holder in due course despite the "without recourse" indorsement? Explain.
2. Had the National Bank given value? Explain.
3. If it be assumed that the National Bank itself cannot qualify as a holder in due course, what alternative course of action is available to it against Baker on the check?
b. Explain the impostor rule and its effect upon the real defense of forgery of a payee's signature.

## Number 5 (Estimated time- 15 to 25 minutes)

Part a. The Sudsy Soap Company received an order from the Williams Wholesale Distributing Corporation for one thousand boxes ( 12 to a box) of Sudsy's best cake soap. The shipment arrived and was accepted by the Williams Corporation. Shortly thereafter Williams discovered that the boxes were somewhat the worse for wear, because they had received rough treatment in handling. Upon opening a random sample of some 50 boxes it was found that the individual packages of each cake were discolored and that many cakes of soap were cracked in half.

Williams tried to sell the soap to its customers and delayed paying Sudsy's bill. After six months had elapsed and Williams saw that there would be a considerable loss in connection with the sale of the soap it notified Sudsy that it would only take the soap at a greatly reduced price and that if Sudsy wouldn't accept this it rescinded the whole transaction. Williams also indicated that under no circumstances would it pay the face value of the bill. Sudsy demands payment in full.

## Required:

1. Is the soap of merchantable quality? Explain what is meant by this term and list the criteria that would be used by the court in determining whether the goods in question are merchantable.
2. Will Sudsy be able to collect the full amount of the price for the soap? Explain.
3. List three remedies that would be available for breach of warranty.

Part b. Define a sale of goods and a trust relationship. Point out the distinctions between the two.

## Number 6 (Estimated time- 15 to 25 minutes)

The XYZ Corporation was to be formed by Peter, a promoter. In order to operate the Corporation after incorporation it was necessary for Peter to obtain stock subscriptions, lease certain facilities and, of course, carry out the mechanics of incorporating. Peter accomplished all these things in short order including the
execution of two separate leases in the corporate name, one covering office space and the other factory space, without revealing to the lessor that the corporation had not yet been organized. The Corporation subsequently came into existence, directors were duly elected, and the board met and took the following action:

1. Accepted all the subscriptions that Peter had obtained.
2. Declined to accept the lease of office space that Peter had executed in the corporate name.
3. Voted to move, and subsequently did move all the Corporation's machinery into the factory that Peter had leased. However, at no time did they vote to accept this lease.
4. Issued $\$ 50$ par value stock to all subscribers; some of the subscribers paid $\$ 25$ per share for the stock which was marked fully paid. These shares were subsequently sold at $\$ 30$ per share to other people who were unaware of the original price paid for the stock.

## Required:

a. According to the prevailing rule, what is the legal status of a preincorporation stock subscription? When does it become binding upon the subscriber? Explain.
b. Can the Corporation validly decline the lease of office space that Peter made in its name? Explain.
c. Does Peter have any liability on any of the leases he made? Explain.
d. Has the Corporation accepted the contract Peter made to lease factory space? Explain.
e. If it be assumed that the Corporation had formally accepted all the above leases, is Peter free from liability? Explain.
f. What rights do creditors of the Corporation have against shareholders who took the newly-issued stock for less than par? Explain.
g. Do the creditors have any rights against the subsequent purchasers of the stock that was issued for less than par? Explain.

## Number 7 (Estimated time- 20 to 25 minutes)

On September 13, 1962, Baker, a New York wholesale beer distributor, received a general advertisement from the Brand X Beer Company of Delaware which indicated it had certain quantities of regular and premium bock beer available in barrels which it wished to sell. On September 18th Baker sent Brand X a telegram as follows: "Relative barrels of bock beer, we order 30 barrels of regular at $\$ 8$ per barrel and 25 barrels of premium at $\$ 10$ per barrel. Order subject to immediate acceptance, prices net, F.O.B. your place of business, wire confirmation and forward papers."

Brand X received this telegram at 11:38 a.m. on September 18th and at 7:14 p.m. of the same day sent Baker a telegraphic night letter stating: "We accept your order as follows: 35 barrels of regular and 22 barrels of premium at the prices and terms indicated in your telegram of the 18th, confirm immediately." This telegram was received at Baker's office on September 19th at 8:29 a.m. At 11:16 a.m. Baker deposited a telegram in the telegraph office, which was received by Brand $\mathbf{X}$ at 12:05 p.m., reading, "We acknowledge your acceptance our order of bock
beer, as modified, forward papers draft attached First City Bank, New York. Wire immediately, our expense, when the papers will go forward."

At 11:02 a.m. that day (19th) Brand X sent Baker a telegram reading as follows: "Cannot hold your offer of September 18th open any longer." This was received by Baker at 11:46 a.m. At noon Brand X sold the beer in question to another firm at $\$ 9$ per barrel for regular bock beer and $\$ 11$ per barrel for premium. These prices represented the prevailing prices of beer at that time.

Baker sues Brand X for breach of contract.

## Required:

a. Indicate the legal effect of each communication commencing with September 13th. Discuss fully.
b. Using the facts and the analysis you made in "a" above, determine whether a contract was made. Explain your reasoning.
c. If it be assumed that a contract did arise, how do you ascertain the contract measure of damages? What amount, in dollars, would be recoverable?

## GROUP II

## (Estimated time- 20 to 25 minutes)

(Answer only one question in this group. If both are answered, only the first will be considered.)

## Number 8

Part a. The Fast Freight Corporation is a common carrier operating in State Y. It contracted with a shipper to transport one thousand transistor radios. The radios were promptly loaded on a truck for delivery, but were delayed in leaving because Fast Freight misplaced the bill of lading. After two days Fast Freight called the shipper and obtained the address of the consignee. During the first day of the shipment torrential rains caused a river to overflow and the truck was in the path of the flood which resulted in damage to the transistors. The shipper sues the carrier. Is Fast Freight liable for the damage to the transistor radios? Explain.

Part b. It has been frequently stated that a common carrier has a duty to serve all parties who wish to avail themselves of the common carrier's services. List four exceptions to this statement.

Part c. Explain the legal relationship between an initial and connecting carrier and the rights and liabilities incident thereto in regard to goods accidentally destroyed in interstate transit while in possession of the connecting carrier.

## Number 9

Part a. The Sherman Act, Section 1, provides: "Every contract, combination, in the form of trust or otherwise, in restraint of trade or commerce among the several states or foreign nations, is hereby declared to be illegal. . . ."

1. What is the "Rule of Reason" and its effect upon the above statute? Explain.
2. Is price fixing subject to the "Rule of Reason"? Explain.

Part b. In our complex economic society, corporate integration has taken three forms, viz.: horizontal, vertical and conglomerate.

1. Explain and illustrate the meaning of these terms.
2. List the Acts which are primarily concerned with the economic integration of businesses.

# EXAMINATION IN THEORY OF ACCOUNTS 

## November 9, 1962; 1:30 p.m. to 5 p.m. (All questions are required.)

## Number 1 (Estimated time- 25 to 30 minutes)

## Instructions

In the cases cited below five different conditions are possible when X is compared with Y. These possibilities are as follows:
a. $X$ equals $Y$.
b. $X$ is greater than $Y$.
c. $X$ is less than $Y$.
d. $X$ is equal to or greater than $Y$.
e. $X$ is equal to or less than $Y$.

On your answer sheet show the relationship of $X$ and $Y$ for each of the following independent statements.

An example of the manner in which the questions should be answered is shown in the following illustration:

Question
Answer
XX. The Effee Co. declared a cash dividend. Compare (X) the amount of the stockholders' equity before the declaration of the b cash dividend with (Y) the amount of the stockholders' equity after the payment of the cash dividend.

## Questions to Be Answered

1. The working capital ratio of the Zeno Co. is 2-to-1. If cash is used to pay a current liability, compare (X) the ratio before payment with (Y) the ratio after payment of the current liability.
2. The Zeno Co. has written off an uncollectible account against the allowance account. Compare the working capital ratio (X) before the write-off with the ratio ( $Y$ ) after the write-off.
3. The cash sale of a fixed asset has resulted in a loss. Compare (X) the working capital ratio before the sale with (Y) the ratio after the sale.
4. The authorized capital stock of the K Corporation consisted of one million shares of $\$ 5$ par value common of which 800,000 shares were issued and outstanding. The balance in the retained earnings account was $\$ 1,260,000$. A $10 \%$ stock dividend was declared and issued when the market value of the stock was
$\$ 7.50$ per share. Compare the total net worth (X) before the issuance of the stock dividend and ( Y ) after the issuance of the stock dividend.
5. Prices have been rising steadily; physical turnover of goods has occurred approximately 4 times in the last year. Compare (X) the ending inventory computed by the LIFO method with ( $\mathbf{Y}$ ) the same ending inventory computed by the moving average method.
6. The retail inventory method has been used by a store during its first year of operation. Compare (X) markdown cancellations with (Y) markdowns.
7. At the beginning of the year a company adopted a new inventory method; the physical quantity of the ending inventory is the same as that of the beginning inventory. Compare ( X ) the reported value of inventory if LIFO was the new method with (Y) the reported value of inventory if the base stock method was the new method.
8. "Cost or market, whichever is lower," may be applied to (X) the inventory as a whole or to ( Y ) categories of inventory items. Compare ( X ) the reported value of inventory when procedure ( X ) is used with ( Y ) the reported value of inventory when procedure ( Y ) is used.
9. Prices have been rising steadily; physical turnover of goods has occurred five times in the last year. Compare (X) unit prices of ending inventory items at moving average pricing with (Y) those at weighted average pricing.
10. The base stock method has been adopted by a company; two periods later prices have fallen $10 \%$ and quantities have increased $3 \%$. Compare (X) the dollar value of the inventory at time of adoption with ( Y ) that of the latest inventory.
11. Steel mill production has averaged $110 \%$ of capacity. Compare (X) the dollar value of ending inventory of work in process under standard costing with (Y) that under absorption costing. Assume that variances arising under standard costing are not apportioned to inventory.
12. In establishing a predetermined burden rate the following flexible budget was prepared:

| Percent Capacity | Estimated Burden |
| :---: | :---: |
| 100 (or normal) | $\$ 500,000$ |
| 90 | 465,000 |
| 80 | 440,000 |
| 70 | 425,000 |

During a month 9,000 units of product ( $90 \%$ of capacity) were produced. Actual burden incurred was $\$ 505,000$. Compare (X) the dollar amount of budget variance with (Y) the dollar amount of volume variance.
13. The following data concerning the sales and collections of Companies $\mathbf{A}$ and $\mathbf{B}$ were compiled from their records:

|  | Company A | Company B |
| :---: | :---: | :---: |
| Sales | \$245,000 | \$90,000 |
| Accounts receivable, Jan. 1 | 20,000 | 4,000 |
| Accounts receivable, Dec. 31 | 15,000 | 8,000 |

Compare ( X ) the average collection period of Company A's accounts receivable with (Y) that of Company B.
14. The following data concerning Companies $\mathbf{A}$ and $\mathbf{B}$ were compiled from their records:

|  | Company A | Company B |
| :---: | :---: | :---: |
| Sales | \$100,000 | \$400,000 |
| Gross profit percentage: |  |  |
| Based on cost price | 25 |  |
| Based on selling price |  | 30 |
| Initial inventory | 30,000 | 160,000 |
| Ending inventory | 34,000 | 90,000 |

Compare (X) Company A's inventory turnover with (Y) that of Company B.
15. Factories A and B each turn out 6,000 units of completed product during June. The following work-in-process statistics are for the month of June:

|  | Initial Inventory |  | Ending Inventory |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Units | \% complete | Units | \% complete |
| Factory A | 1,000 | 80 | 600 | 90 |
| Factory B | 600 | 90 | 1,000 | 80 |

Compare (X) the equivalent production of Factory A with (Y) that of Factory B.

## Number 2 (Estimated time-20 to 25 minutes)

Part a. Many annual reports point out that the reported depreciation charges are based on historical costs and, because of the decline in the purchasing power of the dollar, do not express depreciation expense in terms of current costs.

## Required:

1. Briefly define depreciation. What is the objective of depreciation?
2. Neither depreciation on replacement cost nor depreciation adjusted for changes in the purchasing power of the dollar has been recognized as a generally accepted accounting practice. Briefly present the accounting treatment that might be used to assist in the maintenance of the ability of a company to replace its productive capacity.

Part b. The effectiveness of management in maintaining the purchasing power of capital can be assessed by financial statements developed in terms of uniform "current" dollars to supplement the primary (historical cost) statements.

## Required:

List four other purposes that such supplementary statements might serve.

## Number 3 (Estimated time-20 to 25 minutes)

Many corporations issue quarterly financial statements. In general the accounting concepts underlying these interim statements are the same as those underlying annual statements. However, certain concepts are modified in the development of interim statements because to treat the fiscal quarter as an independent accounting period might limit the usefulness of the interim statements to management, investors and the public.

## Required:

a. On what matters does the knowledgeable reader attempt to draw conclusions from interim financial statements? (Assume the statements are reliable even though they are unaudited.)
b. An objective of income presentation should be the avoidance of any practice that is adopted for the purpose of equalization of reported income. Discuss the modifications, if any, of this generally accepted principle that would be made in developing interim income statements with regard to

1. Sales.
2. Manufacturing costs, including over- or underabsorbed overhead.
3. Selling expenses, including advertising.

## Number 4 (Estimated time- 25 to 30 minutes)

It is not uncommon to find that the net income reported on published financial statements varies from the taxable net income reported to the Internal Revenue Service and other taxing authorities. While the difference between taxable income and accounting net income is directly attributable to different accounting procedures or methods, such difference is indirectly caused by the variance in the objectives of income tax laws and generally accepted accounting principles.

## Required:

a. What are the objectives of generally accepted accounting principles in their application to the income statement? What are the objectives of income tax laws?
b. Differences in accounting methods or procedures under income tax accounting and accounting according to generally accepted principles may be classified into two general groups, those arising from specifications of the tax laws and those caused by timing. Discuss the characteristics of these two groups; use one example of each group in your discussion.
c. The effect of the difference between taxable income and accounting net income is frequently reported in the balance sheet by an account termed "Deferred Income Taxes." List the aguments against including this account as a part of the stockholders' equity.

## Number 5 (Estimated time-25 to 35 minutes)

In the course of his professional activities the CPA is sometimes called upon by his clients for advice regarding the appropriateness of valuing inventories by the LIFO method.

## Required:

a. List the arguments for and against the use of the LIFO method of valuing inventory.
b. What is the dollar-value method of LIFO inventory valuation? (Confine your discussion to the underlying principles; do not discuss the techniques of developing price indexes.) What advantages does the dollar-value method have over the quantity method of LIFO inventory valuation?

## Number 6 (Estimated time- 25 to 35 minutes)

Supporters of direct costing have contended that it provides management with more useful accounting information. Critics of direct costing believe that its negative features outweigh its contributions.

## Required:

a. Describe direct costing. How does it differ from conventional absorption costing?
b. List the arguments for and against the use of direct costing.
c. Indicate how each of the following conditions would affect the amounts of net profit reported under conventional absorption costing and direct costing:

1. Sales and production are in balance at standard volume.
2. Sales exceed production.
3. Production exceeds sales.

## Number 7 (Estimated time- $\mathbf{2 5}$ to 30 minutes)

A common objective of accountants is to present the most accurate income statements that can be prepared. A basic requirement in preparing accurate income statements is properly to match costs against revenues.

## Required:

a. Proper matching of costs against revenues requires that costs resulting from typical business operations be recognized in the period in which they expired. List three criteria that can be used to determine whether such typical costs should appear as charges in the income statement for the current period. (Assume that the income statement is prepared on the all-inclusive basis. Do not discuss the criteria for excluding extraordinary or nonrecurring items from the determination of net income for the year.)
b. As generally presented in financial statements the following items or procedures have been criticized as improperly matching costs with revenues. Briefly discuss each item from the viewpoint of matching costs with revenues and suggest corrective or alternative means of presenting the inancial information.

1. Cash discounts on purchases.
2. Valuation of inventories at the lower of cost or market.
3. Receiving and handling costs.

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[^0]:    \$ 15 per 1000 books
    \$ 1 per 1000 stamps
    $\$ 650$ per 1000 books

[^1]:    *Remaining life, 24 years.

