1976

Uniform CPA examination questions May 1974 to November 1975

American Institute of Certified Public Accountants. Board of Examiners

Uniform CPA Examination

May 1974 to November 1975

Questions

AICPA

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Certified Public Accountants

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FOREWORD

This volume, the seventeenth of its kind, includes the texts of the Uniform Certified Public Accountant Examinations from May 1974 to November 1975 prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia. The sixteen 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 and CPA candidates may be benefited by a review of the unofficial answers published twice a year as a supplement to the *Journal of Accountancy*. Consequently, we are publishing simultaneously with this volume a companion book entitled *Unofficial Answers to the Uniform Certified Public Accountant Examinations, May 1974 to November 1975*, which contains unofficial answers to the questions in this volume.

A special note of thanks is extended to John G. Pate, Jr., University of Texas at El Paso, for the comprehensive index included in this volume. A careful reading of this index may benefit candidates in their review when preparing for future examinations.

Guy W. Trump, *Vice President-Education and Examinations*
American Institute of Certified Public Accountants

April 1976

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Uniform Certified Public Accountant Examination

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING PRACTICE — PART I

May 8, 1974; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	Estimated Minutes *Minimum*	*Maximum*
No. 1	50	60
No. 2	50	60
No. 3	40	50
No. 4	40	50
No. 5	40	50
Total	220	270

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the problems. If more than one page is required for a solution, number the pages in sequence for that problem with the lead schedule first, followed by supporting computations. For instance, if three pages are used for Problem No. 2, you would show Problem 2, Page 1 of 3, Page 2 of 3 and Page 3 of 3.
The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. **Enclose all scratch sheets.** Failure to enclose scratch sheets may result in loss of grading points. Scratch sheets need not have page numbers, but you should show the problem number and place them immediately following the problem to which they relate.

3. Fourteen-column sheets should not be folded until all sheets, both wide and narrow, are placed in the proper sequence and fastened together at the top left corner. All fourteen-column sheets should then be wrapped around the back of the papers.

4. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 50 to 60 minutes)

Instructions

Select the **best** answer for each of the following items relating to a variety of **managerial-accounting problems and quantitative techniques.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to $5,260,000; sales returns and allowances reduced the amounts owed by $160,000. Net sales last year for Baker Company were
   a. $5,260,000.
   b. $5,200,000.
   c. $5,100,000.
   d. $4,800,000.

Answer Sheet

97. a. :::::::: b. ::::::::: c. d. :::::::::

Items to be Answered

1. A planned factory expansion project has an estimated initial cost of $800,000. Using a discount rate of 20%, the present value of future cost savings from the expansion is $843,000. To yield exactly a 20% time-adjusted rate of return, the actual investment cost **cannot** exceed the $800,000 estimate by more than
   a. $160,000.
   b. $20,000.
   c. $43,000.
   d. $1,075.

Items 2 and 3 are based on the following information:

Standard costs and other data for two component parts used by Griffon Electronics are presented below:

	Part A4	*Part B5*
Direct material	$ .40	$ 8.00
Direct labor	1.00	4.70
Factory overhead	4.00	2.00
Unit standard cost	$5.40	$14.70
Units needed per year	6,000	8,000
Machine hours per unit	4	2
Unit cost if purchased	$5.00	$15.00

In past years, Griffon has manufactured all of its required components; however, in 1974 only 30,000 hours of otherwise idle machine time can be devoted to the production of components. Accordingly, some of the parts must be purchased from outside suppliers. In producing parts, factory overhead is applied at $1.00 per standard machine hour. Fixed capacity costs, which will not be affected by any make-buy decision, represent 60% of the applied overhead.

2. The 30,000 hours of available machine time are to be scheduled such that Griffon realizes maximum potential cost savings. The relevant unit production costs which should be considered in the decision to schedule machine time are
   a. $5.40 for A4 and $14.70 for B5.
   b. $5.00 for A4 and $15.00 for B5.
   c. $1.40 for A4 and $12.70 for B5.
   d. $3.00 for A4 and $13.50 for B5.

3. If the allocation of machine time is based upon potential cost savings per machine hour, then Griffon should produce
   a. 3,500 units of A4 and 8,000 units of B5.
   b. 6,000 units of A4 and 8,000 units of B5.
   c. 6,000 units of A4 and 3,000 units of B5.
   d. No units of A4 and 8,000 units of B5.

Items 4 and 5 are based on the following information:

Expected annual usage of a particular raw material is 2,000,000 units, and the standard order size is 10,000 units. The invoice cost of each unit is $500, and the cost to place one purchase order is $80.

4. The average inventory is
   a. 1,000,000 units.
   b. 5,000 units.
   c. 10,000 units.
   d. 7,500 units.

5. The estimated annual order cost is
   a. $16,000.
   b. $100,000.
   c. $32,000.
   d. $50,000.

Items 6 and 7 are based on the following information:

Maintenance expenses of a company are to be analyzed for purposes of constructing a flexible budget. Examination of past records disclosed the following costs and volume measures:

	Highest	*Lowest*
Cost per month	$39,200	$32,000
Machine hours	24,000	15,000

6. Using the high-low-point method of analysis, the estimated variable cost per machine hour is
   a. $1.25.
   b. $12.50.
   c. $0.80.
   d. $0.08.

7. Using the high-low technique, the estimated annual fixed cost for maintenance expenditures is
   a. $447,360.
   b. $240,000.
   c. $230,400.
   d. $384,000.

---

8. Adams Corporation has developed the following flexible-budget formula for annual indirect-labor cost:

Total cost = $4,800 + $0.50 per machine hour

Operating budgets for the current month are based upon 20,000 hours of planned machine time. Indirect-labor costs included in this planning budget are
   a. $14,800.
   b. $10,000.
   c. $14,400.
   d. $10,400.

Items 9 and 10 are based on the following information:

Gyro Gear Company produces a special gear used in automatic transmissions. Each gear sells for $28, and the Company sells approximately 500,000 gears each year. Unit cost data for 1973 are presented below:

Direct material	$6.00	
Direct labor	5.00	
	Variable	*Fixed*
Other costs:		
Manufacturing	$2.00	$7.00
Distribution	4.00	3.00

9. The unit cost of gears for direct-cost-inventory purposes is
   a. $13.
   b. $20.
   c. $17.
   d. $27.

10. Gyro has received an offer from a foreign manufacturer to purchase 25,000 gears. Domestic sales would be unaffected by this transaction. If the offer is accepted, variable distribution costs will increase $1.50 per gear for insurance, shipping, and import duties. The relevant unit cost to a pricing decision on this offer is
   a. $17.00.
   b. $14.50.
   c. $28.50.
   d. $18.50.

Items 11 and 12 are based on the following information:

From a particular joint process, Watkins Company produces three products, X, Y, and Z. Each product may be sold at the point of split-off or processed further. Additional processing requires no special facilities, and production costs of further processing are entirely variable and traceable to the products involved. In 1973, all three products were processed beyond split-off. Joint production costs for the year were $60,000. Sales values and costs needed to evaluate Watkins' 1973 production policy follow:

			Additional Costs and Sales Values if Processed Further	
Product	*Units Produced*	*Sales Values at Split-Off*	*Sales Values*	*Added Costs*
X	6,000	$25,000	$42,000	$9,000
Y	4,000	41,000	45,000	7,000
Z	2,000	24,000	32,000	8,000

Joint costs are allocated to the products in proportion to the relative physical volume of output.

11. For units of Z, the unit production cost most relevant to a sell-or-process-further decision is
   a. $5.
   b. $12.
   c. $4.
   d. $9.

12. To maximize profits, Watkins should subject the following products to additional processing
   a. X only.
   b. X, Y, and Z.
   c. Y and Z only.
   d. Z only.

---

13. A sales office of Helms, Inc., has developed the following probability distribution for daily sales of a perishable product.

X (Units Sold)	*P (Sales = X)*
100	.2
150	.5
200	.2
250	.1

The product is restocked at the start of each day. If the Company desires a 90% service level in satisfying sales demand, the initial stock balance for each day should be

a. 250.
b. 160.
c. 200.
d. 150.

14. A quantitative technique which deals with the problem of supplying sufficient facilities to meet the needs of production lines or individuals that demand service unevenly is

a. Regression analysis.
b. PERT.
c. Queuing theory.
d. Curvilinear analysis.

15. A formal diagram of the interrelationships of complex time series of activities is

a. PERT.
b. The method of least squares.
c. Linear programming.
d. Poisson distribution models.

16. A quantitative technique used to discover and evaluate possible cause-and-effect relationships is

a. Linear programming.
b. PERT.
c. Poisson distribution models.
d. Correlation analysis.

17. A quantitative technique used to make predictions or estimates of the value of a dependent variable from given values of an independent variable(s) is

a. Linear programming.
b. Regression analysis.
c. Trend analysis.
d. Queuing theory.

18. A quantitative technique used for selecting the combination of resources that maximizes profits or minimizes costs is

a. Curvilinear analysis.
b. Queuing theory.
c. Dynamic programming.
d. Linear programming.

Number 2 (Estimated time — 50 to 60 minutes)

You have been assigned to the audit of Wright, Inc., a manufacturing company. You have been asked to summarize the transactions for the year ended December 31, 1973, affecting stockholders' equity and other related accounts, particularly investments and long-term liabilities. The stockholders' equity section of Wright's December 31, 1972, balance sheet follows:

Stockholders' Equity

Common stock, par value $10; shares authorized 500,000; shares issued 90,000	$ 900,000
Capital in excess of par value	11,250
Retained earnings	424,689
Less cost of 1,210 shares of common stock in treasury	(36,300)
Total	$1,299,639

You have extracted the following information from the accounting records and audit working papers.

1. On January 15, 1973, 650 shares of treasury stock were sold for $20 per share. The 1,210 shares of treasury stock on hand at December 31, 1972, were purchased in one block in 1968. Wright used the cost method for recording the treasury shares purchased.

2. On January 26, 1973, a 5% stock dividend was declared and issued in early February to stockholders of record on January 31.

3. On February 2, 1973, ninety, $1,000 5-1/2% bonds due February 1, 1976, were sold at 104 with one detachable stock purchase warrant attached to each bond. Interest is payable annually on February 1. The fair value of the bonds without the stock warrants is 98-4/5. The detached warrants have a fair value of $52 each and expire on February 1, 1974. Each warrant entitles the holder to

purchase ten shares of common stock at $30 per share. On November 1, 1973, fifty-five stock warrants detached from the bonds were exercised.

4. On March 6, 1973, subscriptions for 1,400 shares of common stock were issued at $22 per share, payable 50% down and the balance by March 20. On March 20 the balance due on 1,200 shares was received and those shares were issued. The subscriber who defaulted on the 200 remaining shares forfeited his down payment in accordance with the subscription agreement.

5. On March 31, 1973, Wright paid $146,960 cash for all of the stock of Buller Company. A summary of Buller's adjusted trial balance including operations for the three months ended March 31, 1973, follows. Fair market value (FMV) is shown parenthetically when different from book value.

Receivables	$ 28,901
Land (FMV $96,000)	78,000
Other assets	12,876
Liabilities	(35,777)
Common stock	(22,180)
Paid-in capital	(26,320)
Retained earnings	(25,299)
Revenues	(97,249)
Expenses	87,048
	$ 0

The excess cost over the sum of the fair values of the net assets acquired as shown on the above adjusted trial balance was deemed attributable to the future earnings potential of Buller. This excess cost should be amortized over the maximum period recommended by generally accepted accounting principles.

Earnings of Buller from January 1 to March 31, 1973, were $10,201; earnings from April 1 to December 31, 1973, were $14,434.

Buller is to retain its separate corporate identity and operate as a subsidiary. There were no intercompany accounts requiring elimination or adjustment at December 31, 1973. Wright desires to maintain its accounting records to produce information for the preparation of its statements (unconsolidated) for issuance to stockholders as the financial statements of the primary reporting entity.

6. On August 31, 1973, Wright exchanged 12,400 previously authorized but unissued shares of its common stock for all of the stock of Clark Corporation. A summary of Clark's balance sheet at August 31, 1973, follows.

Assets

Assets	$318,000
	$318,000

Liabilities and Stockholders' Equity

Liabilities	$ 39,366
Common stock ($1 par)	104,000
Paid-in capital	80,243
Retained earnings	94,391
	$318,000

The combination was appropriately accounted for as a pooling of interests. Clark's retained earnings included $17,426 of earnings from January 1 to August 31, 1973. Clark's earnings from September 1 to December 31, 1973, were $8,111.

Clark is to retain its separate corporate identity and operate as a subsidiary. In accordance with generally accepted accounting principles, the investment in Clark on Wright's books is to be recorded at the book value of the net assets acquired as shown on the above balance sheet; stockholders' equity accounts are to be charged and credited in the same manner as if the companies were combined (or consolidated). Wright will continue to account for its investment in Clark by the equity method. There were no intercompany accounts requiring elimination or adjustment at December 31, 1973.

Other data:

The market price at which Wright's common stock traded on a midwest exchange at various dates follows.

January 2	$19	July 5	$32
January 15	20	August 1	32
January 26	21	August 31	33
March 30	22	September 4	34
April 2	22	October 1	33
May 1	28	November 1	36
June 1	31	December 3	38
June 30	32	December 31	42

Required:

Complete the worksheet on page 6 to summarize the above transactions of Wright. Your analysis should be presented in the same order as the facts are given with corresponding numbers 1 through 6. Entries at December 31, 1973, for bond interest and bond premium and/or discount amortization **are not required**. Round all final calculations to the nearest dollar. **Ignore income taxes.**

Wright, Inc.

TRANSACTIONS AFFECTING STOCKHOLDERS' EQUITY AND OTHER RELATED ACCOUNTS

Year Ended December 31, 1973

(Required for Number 2)

No.	Description	Common Stock Dr. (Cr.)	Common Stock Subscribed Dr. (Cr.)	Capital in Excess of Par Value Dr. (Cr.)	Treasury Stock Dr. (Cr.)	Cash Dr. (Cr.)	Subscriptions Receivable Dr. (Cr.)	Investments Dr. (Cr.)	Equity in Earnings of Unconsolidated Subsidiaries Dr. (Cr.)	Other Accounts: Account	Other Accounts: Amount Dr. (Cr.)
	Opening balances	$ (900,000)	$ –	$ (11,250)	$ 36,300	$ –	$ –	$ –	$ –	Retained earnings	$(424,689)

Number 3 (Estimated time — 40 to 50 minutes)

Bates Corporation, a manufacturer, is a solvent, domestic, calendar-year, accrual-basis taxpayer. All of the corporation's outstanding stock is owned equally by two brothers, John and Fred Bates. The controller has been unable to compute the corporation's 1973 taxable income or tax liability because he is unfamiliar with the tax treatment of several property dispositions. You have been requested to assist the controller in determining the appropriate tax treatment of the property dispositions in question and to determine the corporation's 1973 taxable income.

The controller has prepared a schedule of these dispositions and a memorandum of significant information relevant to these properties. All depreciation has been correctly computed and recorded on the books by the controller, but no entries have been made to adjust the asset and related accounts for the property dispositions. The controller's schedule and memorandum appear below.

Schedule of Property Dispositions*

	Cost	*Accumulated Depreciation*	*Cash Proceeds*	*Fair Market Value*	*Nature of Disposition*
Merchandise inventory	$ 4,800	$ –	$ –	$ 7,000	Distribution
Marketable securities	8,300	–	–	9,650	Consulting fee
Marketable securities	3,500	–	–	4,400	Settlement of debt
Land	22,000	–	20,000	20,000	Condemnation
Building	6,800	–	2,100	–	Demolition
Warehouse	60,000	7,978	58,000	58,000	Destruction by fire
Machine	4,000	1,700	600	3,300	Trade-in
Furniture	8,200	6,560	–	1,900	Contribution
Automobile	6,000	2,250	3,000	4,300	Sale
Investment – Subo Corp.	16,500	–	–	–	Worthless security
Patent	13,000	–	31,000	31,000	Sale

*All property disposed of has been held for more than six months.

Additional information regarding the property dispositions follows:

Merchandise inventory On January 22, inventory, priced by the FIFO method, was distributed to a stockholder who assumed a $5,600 account payable in connection with the distribution.

Marketable securities On May 8, certain securities were transferred to a nonstockholder as a fee for consulting services of $9,650 in connection with current operations. Other securities were transferred to him in settlement of a $4,400 liability appearing on the corporate books.

Land On February 15, a condemnation award was received as consideration for unimproved land held primarily as an investment, and on March 31, another parcel of unimproved land to be held as an investment was purchased at a cost of $21,500.

Building On April 2, land and building were purchased at a total cost of $34,000 of which 20% was allocated to the building on the corporate books. The real estate was acquired with the intention of demolishing the building and this was accomplished during the month of November. Cash proceeds received in November represent the net proceeds from demolition of the building.

Warehouse On June 30, the warehouse was destroyed by fire. The warehouse was purchased January 2, 1970, and had a useful life of 50 years. Depreciation was claimed under the declining-balance method (two times the straight-line rate) with no estimated salvage value. On December 27, part of the insurance proceeds was used to purchase a replacement warehouse at a cost of $53,000.

Machine On December 26, the machine was exchanged for another machine having a fair market value of $2,700 and cash of $600 was received.

Furniture On August 15, furniture was contributed to a qualified charitable organization. No other contributions were made or pledged during 1973.

Automobile On November 3, the automobile was sold to Fred Bates, a stockholder.

Investment in Subo Corp. On December 31, the stock of Subo Corp. was declared worthless. The investment represents ownership of 100% of the stock of Subo, which has always derived all of its gross income from manufacturing operations. Subo has never filed a consolidated tax return with Bates.

Patent On November 18, the patent was sold to an independent third party. The patent had been held as an investment.

Required:

Assuming Bates Corporation's net income before accounting for the disposition of the above property is $23,650, prepare a schedule calculating the corporation's unconsolidated taxable income for 1973 in accordance with the current Internal Revenue Code and Tax Regulations. Indicate whether each gain or loss is capital or ordinary. Include supporting schedules in good form for the disposition of the warehouse, machine, and furniture.

Number 4 (Estimated time — 40 to 50 minutes)

Ruwe Corporation has decided that in the preparation of its 1973 financial statements two changes will be made from the methods used in prior years:

1. Depreciation. Ruwe has always used the declining-balance method for tax and financial reporting purposes but has decided to change during 1973 to the straight-line method for financial reporting only. The effect of this change is as follows:

	Excess of Accelerated Depreciation Over Straight-line Depreciation
Prior to 1972	$1,300,000
1972	101,000
1973	99,000
	$1,500,000

Depreciation is charged to cost of sales and to selling, general, and administrative expenses on the basis of 75% and 25%, respectively.

2. Bad debt expense. In the past Ruwe has recognized bad debt expense equal to 1.5% of net sales. After careful review it has been decided that a rate of 2% is more appropriate for 1973. Bad debt expense is charged to selling, general, and administrative expenses.

The following information is taken from preliminary financial statements, prepared before giving effect to the two changes:

Ruwe Corporation
CONDENSED BALANCE SHEET
December 31, 1973
With Comparative Figures for 1972

	1973	*1972*
Assets		
Current assets	$43,561,000	$43,900,000
Fixed assets, at cost	45,792,000	43,974,000
Less accumulated depreciation	23,761,000	22,946,000
	$65,592,000	$64,928,000
Liabilities and Stockholders' Equity		
Current liabilities	$21,124,000	$23,650,000
Long-term debt	15,154,000	14,097,000
Capital stock	11,620,000	11,620,000
Retained earnings	17,694,000	15,561,000
	$65,592,000	$64,928,000

Ruwe Corporation
INCOME STATEMENT
For the Year Ended December 31, 1973
With Comparative Figures for 1972

	1973	*1972*
Net sales	$80,520,000	$78,920,000
Cost of sales	54,847,000	53,074,000
	25,673,000	25,846,000
Selling, general, and administrative expenses	19,540,000	18,411,000
	6,133,000	7,435,000
Other income (expense), net	(1,198,000)	(1,079,000)
Income before federal income taxes	4,935,000	6,356,000
Federal income taxes	2,368,800	3,050,880
Net income	$ 2,566,200	$ 3,305,120

There have been no timing differences between any book and tax items prior to the above changes. The effective tax rate is 48%.

Required:

Based on APB Opinion No. 20, "Accounting Changes," compute for the items listed below the amounts which would appear on the comparative (1973 and 1972) financial statements of Ruwe Corporation after adjustment for the two accounting changes. Show amounts for both 1973 and 1972 and prepare supporting schedules as necessary.

- **a.** Accumulated depreciation.
- **b.** Deferred tax liability.
- **c.** Selling, general, and administrative expenses.
- **d.** Current portion of federal income tax expense.
- **e.** Deferred portion of federal income tax expense.
- **f.** Retained earnings.
- **g.** Pro forma net income.

Number 5 (Estimated time — 40 to 50 minutes)

Bencivenga Company has prepared its financial statements for the year ended December 31, 1973, and for the three months ended March 31, 1974. You have been asked to prepare a statement of changes in financial position on a working capital basis for the three months ended March 31, 1974. The company's balance sheet data at December 31, 1973, and March 31, 1974, and its income statement data for the three months ended March 31, 1974, follow. You have previously satisfied yourself as to the correctness of the amounts presented.

	Balance Sheet	
	December 31, 1973	*March 31, 1974*
Cash	$ 25,300	$ 87,400
Marketable investments	16,500	7,300
Accounts receivable, net	24,320	49,320
Inventory	31,090	48,590
Total current assets	$ 97,210	$192,610
Land	40,000	18,700
Building	250,000	250,000
Equipment	–	81,500
Accumulated depreciation	(15,000)	(16,250)
Investment in 30%-owned company	61,220	67,100
Other assets	15,100	15,100
Total	$448,530	$608,760
Accounts payable	$ 21,220	$ 17,330
Dividend payable	–	8,000
Income taxes payable	–	34,616
Total current liabilities	$ 21,220	$ 59,946
Other liabilities	186,000	186,000
Bonds payable	50,000	115,000
Discount on bonds payable	(2,300)	(2,150)
Deferred income taxes	510	846
Preferred stock	30,000	–
Common stock	80,000	110,000
Dividends declared	–	(8,000)
Retained earnings	83,100	147,118
Total	$448,530	$608,760

	Income Statement Data For the Three Months Ended March 31, 1974
Sales	$242,807
Gain on sale of marketable investments	2,400
Equity in earnings of 30%-owned company	5,880
Gain on condemnation of land	10,700
	$261,787
Cost of sales	138,407
General and administrative expenses	22,010
Depreciation	1,250
Interest expense	1,150
Income taxes	34,952
	$197,769
Net income	$ 64,018

Your discussion with the company's controller and a review of the financial records have revealed the following information.

1. On January 8, 1974, the company sold marketable securities for cash. These securities had been held for more than six months.
2. The company's preferred stock is convertible into common stock at a rate of one share of preferred for two shares of common. The preferred stock and common stock have par values of $2 and $1, respectively.
3. On January 17, 1974, three acres of land were condemned. An award of $32,000 in cash was received on March 22, 1974. Purchase of additional land as a replacement is not contemplated by the company.
4. On March 25, 1974, the company purchased equipment for cash.
5. On March 29, 1974, bonds payable were issued by the company at par for cash.
6. The investment in 30%-owned company included an amount attributable to goodwill of $3,220 at December 31, 1973. Goodwill is being amortized at an annual rate of $480.
7. The company's tax rate is 40% for regular income and 20% for capital gains.

Required:

Prepare in good form a statement of changes in financial position, including any supporting schedules needed, on a working capital basis for Bencivenga Company for the three months ended March 31, 1974.

Uniform Certified Public Accountant Examination

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING PRACTICE — PART II

May 9, 1974; 1:30 to 6:00 P.M.

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2. **Enclose all scratch sheets.** Failure to enclose scratch sheets may result in loss of grading points. Scratch sheets need not have page numbers, but you should show the problem number and place them immediately following the problem to which they relate.

3. Fourteen-column sheets should not be folded until all sheets, both wide and narrow, are placed in the proper sequence and fastened together at the top left corner. All fourteen-column sheets should then be wrapped around the back of the papers.

4. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time -- 40 to 50 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of financial-accounting problems.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to $5,260,000; sales returns and allowances reduced the amounts owed by $160,000. Net sales last year for Baker Company were
   a. $5,260,000.
   b. $5,200,000.
   c. $5,100,000.
   d. $4,800,000.

Answer Sheet

97. a. :::::::: b. ::::::::: c. ▬ d. :::::::::

Items to be Answered

1. On January 2, 1973, MacAngus Co., as lessor, leased machinery to Yen Co. for $1,000 per year for ten years. The machinery is manufactured by MacAngus at a cost of $4,000 and has a normal selling price of $6,000. If Yen Co. had borrowed money to purchase the machinery outright, it would have had to pay interest at 12%. The estimated salvage value of the machinery at the end of its ten years of useful life is $1,000.

The present value of $1 for 10 periods at 12% per period is $.322.

The present value of an annuity of $1 per period for 10 periods at 12% per period is $5.650.

Assume that this lease is, in substance, an installment sale of the property by MacAngus. **Ignoring income taxes,** the amount of gross profit which MacAngus should recognize at the date the lease is signed is
   a. $2,000.
   b. $1,650.
   c. $650.
   d. $1,328.

2. On January 2, 1969, Lewis Corporation issued $1,000,000 of 8% bonds at 98 due December 31, 1978. Legal and other costs of $30,000 were incurred in connection with the issue. Interest on the bonds is payable annually each December 31. The $30,000 issue costs are being deferred and amortized on a straight-line basis over the ten-year term of the bonds. The discount on the bonds is also being amortized on a straight-line basis over the ten years (straight-line being immaterially different in effect from the preferable "interest method").

The bonds are callable at 101 (that is, at 101% of face amount), and on January 2, 1974, Lewis called $500,000 face amount of the bonds and retired them.

Ignoring income taxes, the amount of loss, if any, to be recognized by Lewis as a result of retiring the $500,000 of bonds in 1974 is
   a. $0.
   b. $5,000.
   c. $10,000.
   d. $17,500.

Items 3, 4, and 5 are based on the following information:

On January 1, 1973, Lodge Co. sold machinery on the following terms: The buyer signed a noninterest-bearing note obligating him to pay $1,000 per year for ten years, the first payment to be made on December 31, 1973. Had the buyer tried to arrange for financing of the purchase through an independent financing institution, a 10% rate of interest would have been charged. In this situation, APB Opinion No. 21 requires that interest be imputed for financial-reporting purposes.

Assume that, for income tax purposes, interest must also be imputed, but at a 5% rate. Lodge's income tax rate is 50%.

The following are taken from tables of present values:

Present value of $1 for 10 periods

5% per period	$0.6139
10% per period	$0.3855

Present value of an annuity of $1 per period for 10 periods

5% per period	$7.7217
10% per period	$6.1446

3. The amount which should be recorded by Lodge for financial-reporting purposes as a discount on the note receivable at January 1, 1973, is (rounded to the nearest dollar)
   a. $6,145.
   b. $3,855.
   c. $2,278.
   d. $1,577.

4. The amount which should be recorded by Lodge on January 1, 1973, as deferred income taxes relative to the sale of the machinery is
   a. $1,928.
   b. $789.
   c. $1,139.
   d. $0.

5. In 1973, Lodge should recognize interest income on the note of
   a. $386.
   b. $1,000.
   c. $614.
   d. $772.

---

6. Baker Co., a manufacturer, had inventories at the beginning and end of its current year as follows:

	Beginning	*End*
Raw materials	$22,000	$30,000
Work in process	40,000	48,000
Finished goods	25,000	18,000

During the year the following costs and expenses were incurred:

Raw materials purchased	$300,000
Direct-labor cost	120,000
Indirect factory labor	60,000
Taxes and depreciation on factory building	20,000
Taxes and depreciation on salesroom and office	15,000
Salesmen's salaries	40,000
Office salaries	24,000
Utilities (60% applicable to factory, 20% to salesroom, and 20% to office)	50,000

Baker's cost of goods sold for the year is
   a. $514,000.
   b. $521,000.
   c. $522,000.
   d. $539,000.

Items 7 and 8 are based on the following information:

Pacter Co., an installment seller, earns a $300 pretax gross profit on each installment sale. For financial-reporting purposes the entire $300 is recognized at the time of sale, but for income tax purposes the installment method of accounting is used.

Assume Pacter makes one sale in 1971, another sale in 1972, and a third sale in 1973. In each case, one-third of the gross sales price is collected in the year of sale, one-third in the next year, and the final installment in the next year.

7. Assuming an income tax rate of 50%, the amount which should be shown on Pacter's December 31, 1973, balance sheet as "deferred income taxes" relative to the three sales is
   a. $100.
   b. $150.
   c. $200.
   d. $300.

8. Assume that on January 1, 1973, the tax rate increased to 60% from 50%. The appropriate amount to report as "deferred income taxes" under the "gross change method" on Pacter's December 31, 1973, balance sheet is
   a. $120.
   b. $170.
   c. $270.
   d. $300.

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9. On January 2, 1973, Lang Co. issued at par $10,000 of 4% bonds convertible in total into 1,000 shares of Lang's common stock. These bonds are common stock equivalents for purposes of computing earnings per share. No bonds were converted during 1973.

Throughout 1973 Lang had 1,000 shares of common stock outstanding. Lang's 1973 net income was $1,000. Lang's income tax rate is 50%.

No potentially dilutive securities other than the convertible bonds were outstanding during 1973. Lang's primary earnings per share for 1973 would be
   a. $1.00.
   b. $.50.
   c. $.70.
   d. $.60.

10. Certain information relative to the 1973 operations of Foley Co. follows:

Accounts receivable, January 1, 1973	$ 8,000
Accounts receivable collected during 1973	26,000
Cash sales during 1973	5,000
Inventory, January 1, 1973	12,000
Inventory, December 31, 1973	11,000
Purchases of inventory during 1973	20,000
Gross profit on sales (gross margin)	9,000

What is Foley's accounts-receivable balance at December 31, 1973?
   a. $7,000.
   b. $12,000.
   c. $17,000.
   d. $13,000.

11. On January 2, 1973, Ben Co. purchased 40% of the outstanding common stock of Clarke Co. for $1,000. On that date, Clarke's net assets were $2,000 and Ben cannot attribute the excess of the cost of its investment in Clarke over its equity in Clarke's net assets to any particular factor.

Clarke's 1973 net income is $250. Ben plans to retain its investment in Clarke indefinitely. Ben accounts for its investment in Clarke by the equity method. The maximum amount which could be included in Ben's 1973 income before taxes to reflect Ben's "equity in net income of Clarke" is
   a. $95.
   b. $100.
   c. $200.
   d. $245.

12. On December 31, 1973, the stockholders' equity section of the balance sheet of Mason Co. was as follows:

Common stock (Par value \$1, 1,000 shares authorized, 300 shares issued and outstanding)	\$ 300
Additional paid-in capital	1,800
Retained earnings	2,000
	\$4,100

On January 2, 1974, the board of directors declared a stock dividend of one share for each three shares owned. Accordingly, 100 additional shares of stock were issued. On January 2 the fair market value of Mason's stock was \$10 per share.

The most appropriate presentation of Mason's stockholders' equity on January 2, 1974, following the issuance of the 100 additional shares is

a.

Common stock (Par value \$1, 1,000 shares authorized, 400 shares issued and outstanding)	\$ 400
Additional paid-in capital	1,700
Retained earnings	2,000
	\$4,100

b.

Common stock (Par value \$1, 1,000 shares authorized, 400 shares issued and outstanding)	\$ 400
Additional paid-in capital	1,800
Retained earnings	1,900
	\$4,100

c.

Common stock (Par value \$1, 1,000 shares authorized, 400 shares issued and outstanding)	\$ 400
Additional paid-in capital	2,700
Retained earnings	1,000
	\$4,100

d.

Common stock (Par value \$1, 1,000 shares authorized, 400 shares issued and outstanding)	\$ 400
Additional paid-in capital	2,400
Retained earnings	1,300
	\$4,100

13. The 1973 net income of Mack Co. was \$100,000, and 100,000 shares of its common stock were outstanding during the entire year. In addition, there were outstanding options to purchase 10,000 shares of common stock at \$10 per share. These options were granted in 1971 and none had been exercised by December 31, 1973. Market prices of Mack's common stock during 1973 were:

January 1	\$20 per share
December 31	\$40 per share
Average price	\$25 per share

The amount which should be shown as Mack's fully diluted earnings per share for 1973 is (rounded to the nearest cent)

a. $\frac{\$100{,}000}{110{,}000 \text{ shares}} = \$.91.$

b. $\frac{\$100{,}000}{105{,}000 \text{ shares}} = \$.95.$

c. $\frac{\$100{,}000}{106{,}000 \text{ shares}} = \$.94.$

d. $\frac{\$100{,}000}{107{,}500 \text{ shares}} = \$.93.$

14. Goldstein Co., a specialty clothing store, uses the retail-inventory method. The following information relates to 1973 operations:

Inventory January 1, 1973, at cost	\$14,200
Inventory January 1, 1973, at sales price	20,100
Purchases in 1973 at cost	32,600
Purchases in 1973 at sales price	50,000
Additional markups on normal sales price	1,900
Sales (including \$4,200 of items which were marked down from \$6,400)	60,000

The cost of the December 31, 1973, inventory determined by the retail-inventory method is

a. \$9,800.
b. \$6,370.
c. \$6,743.
d. \$6,543.

15. On January 1, 1973, Ramos Co. signed a ten-year noncancellable lease for certain machinery. The terms of the lease call for payments of \$10,000 per year to be made by Ramos for ten years.

The machinery has a twenty-year life and no salvage value. Ramos uses the straight-line depreciation method on all depreciable assets.

Assume that, in substance, this lease is an installment purchase of the machinery by Ramos, and accordingly should be capitalized. Assuming a 10% discount rate, the lease payments have a present value of \$61,440.

Relative to the capitalized lease described above, Ramos' 1973 income statement should include

a. Interest expense of \$10,000, and depreciation expense of \$3,072.
b. Interest expense of \$10,000 only.
c. Interest expense of \$6,144 and depreciation expense of \$3,072.
d. Interest expense of \$6,928 and depreciation expense of \$3,072.

16. On July 1, 1973, Custer Co. granted John Jones, an employee, an option to buy 100 shares of Custer Co. stock for $20 per share, the option exercisable for five years from date of grant. Jones exercised his option on September 1, 1973, and sold his 100 shares on December 1, 1973.

Quoted market prices of Custer Co. stock during 1973 were:

July 1	$20 per share
September 1	$24 per share
December 1	$27 per share

As a result of the option granted to Jones, Custer should recognize compensation expense on its books in the amount of

a. $0.
b. $300.
c. $400.
d. $700.

Number 2 (Estimated time -- 40 to 50 minutes)

Instructions

Select the **best** answer for each of the following items relating to **the federal income taxation of individuals.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. The answers should be selected in accordance with the **current Internal Revenue Code and Tax Regulations. Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

17. Elizabeth Moore owned a 50% interest in a partnership in which capital is a material income-producing factor. Effective January 1, 1973, pursuant to a model custodian act, she gave 10% of her interest to her minor nephew and a 20% interest to her minor niece. The nephew's distributive share of income is used to satisfy part of his father's (Mrs. Moore's brother) support obligation, while the niece's share is deposited in her own savings account. Assuming the partnership income for 1973 is $10,000, Mrs. Moore's original 50% distributive share should be included in the respective gross incomes of

a. Mrs. Moore as $4,000 and her niece as $1,000.
b. Mrs. Moore as $3,500 and her brother as $1,500.
c. Mrs. Moore as $3,500, her niece as $1,000, and her brother as $500.
d. Mrs. Moore as $3,500, her niece as $1,000, and her nephew as $500.
e. None of the above.

18. Bill Walden received a $2,100 grant from his employer and, as required by his employer, used the money to take three graduate-school courses during the period September 1 to December 31, 1973. Walden is not a candidate for a degree and has never received a scholarship or fellowship grant before. He had previously met the minimum educational requirements for his employment position; however, due to new requirements established by his employer, these courses were necessary for him to retain his job. In computing his 1973 taxable income, Walden should include

a. Gross income of $2,100 and an education expense deduction of $2,100.
b. Gross income of $2,100 and no education expense deduction.
c. Gross income of $900 and an education expense deduction of $2,100.
d. Gross income of $0 and an education expense deduction of $2,100.
e. None of the above.

19. The following information is available with respect to a stock option granted to Paul Sanders by his employer pursuant to an employee stock purchase plan:

	Per Share
Fair market value on the date of grant, March 1, 1970	$10.00
Option price on the date of grant, March 1, 1970	9.00
Fair market value on the date of exercise, July 1, 1972	9.70
Selling price on August 1, 1973	11.00
Number of shares acquired and sold: 100	

The effect on Sanders' 1973 taxable income resulting from the sale of the 100 shares should be

a. Long-term capital gain of $200.
b. Long-term capital gain of $130.
c. Long-term capital gain of $130; ordinary income of $70.
d. Long-term capital gain of $100; ordinary income of $100.
e. None of the above.

20. Bob Jones is sole beneficiary of a trust which requires that all income, but no corpus, be distributed currently. The trust's distributable net income for 1973 was $20,000, of which $4,000 is a long-term capital gain allocated to income and $2,500 is interest on municipal bonds. Jones received a $15,000 distribution on December 20, 1973, and the remaining $5,000 on January 10, 1974. Assuming Jones has no other income for 1973, his adjusted gross income should be

a. $15,500.
b. $13,500.
c. $13,125.
d. $11,625.
e. None of the above.

21. On December 20, 1973, Mr. and Mrs. Garrison purchased four tickets for a New Year's Eve party at their church, a qualified charitable organization. Each ticket cost $75 and had a fair market value of $50. The Garrisons gave two of the tickets to a needy family in the community. Mr. Garrison tended bar at the party from 8 PM to 4 AM and was paid $40. The usual charge for such services is $80. Immediately before midnight, Mr. Garrison pledged $200 to the building fund and delivered a check for that amount on January 2, 1974. Of the amounts described above, the total amount which the Garrisons can include as a charitable contribution deduction for 1973 on a joint return is

a. $340.
b. $140.
c. $100.
d. $50.
e. None of the above.

22. On January 24, 1973, Mike Dalton sold stock with a cost of $3,800 to his brother Ned for $3,000, its fair market value. On April 20, 1973, Ned sold the same stock for $3,600 to a friend in a bona fide transaction. In 1973 as a result of these transactions

a. Ned has a nonrecognized gain of $600.
b. Ned has a recognized gain of $600.
c. Ned has a recognized loss of $200.
d. Mike has a recognized loss of $800.
e. None of the above.

23. On February 15, 1973, Barry Waters, age 52, sold his personal residence which was purchased May 8, 1965, at a cost of $35,000. The contract price was $50,000, and he received a down payment of $12,500. No other payments were received in 1973, and Mr. Waters elected to report the sale on the installment method. On October 10, 1973, he purchased another principal residence at a price of $45,000. The 1973 tax effect of these transactions, before considering the 50% long-term capital gain deduction and disregarding selling expense or other adjustments to basis and imputed interest, should be

a. Recognized gain of $3,750 and a basis of the new residence of $45,000.
b. Recognized gain of $3,750 and a basis of the new residence of $35,000.
c. Recognized gain of $1,250 and a basis of the new residence of $40,000.
d. Recognized gain of $1,250 and a basis of the new residence of $35,000.
e. None of the above.

24. On March 12, 1973, Ivan Turner was injured in a truck accident in the course of his employment. As a result of injuries sustained, he received the following payments in 1973:

Damages for personal injuries	$5,000
Workmen's compensation	500
Reimbursement from his employer's accident and health plan for medical expenses paid by Turner in 1973. (The employer's contribution to the plan was $75 in 1973.)	750

The amount to be included in Turner's 1973 gross income should be

a. $6,250.
b. $5,000.
c. $750.
d. $75.
e. None of the above.

25. On January 2, 1971, Mary Strom received a gift of an electric typewriter with a fair market value of $350 and an original cost (basis) to the donor of $500. There was no applicable gift tax. During 1971 and 1972 the typewriter was used in Strom's business and depreciated on the straight-line basis over a ten-year remaining useful life with no salvage value. On January 2, 1973, it was sold for $280. The loss that Strom can deduct in computing her 1973 taxable income is

a. $0.
b. $70.
c. $120.
d. $220.
e. None of the above.

26. Al Rivers, a cash basis taxpayer, died on September 30, 1973. From January 1 until his death he received a salary of $15,000. In addition, he earned commissions of $6,500 which were **not** received, although a check for $2,000 had been available since September 15, 1973. On December 15, 1973, Mr. Rivers' widow, Paula, received a $6,000 death benefit from his employer in consideration of his past services rendered. Assuming a joint return is properly filed, gross income of Mrs. Rivers and the decedent for 1973 should be

a. $27,500.
b. $23,000.
c. $18,000.
d. $16,000.
e. None of the above.

27. Arnold and Jane Stevens were divorced in February 1973. Specific requirements of the divorce decree and Mr. Stevens' performance of those requirements follow:

- Transfer title in the personal residence to Jane as part of a lump sum property settlement. On the day of transfer his basis was $24,000, the fair market value was $27,000, and the property was subject to a mortgage of $20,000.
- Make the mortgage payments on the twenty-year mortgage. He paid $1,000 in 1973.
- Pay Jane $525 per month of which $300 is specified as child support. He made ten such payments in 1973.
- Repay a $1,500 loan to Jane which he did on March 1, 1973.

Assuming Jane Stevens has no other income, her 1973 gross income should be

a. $6,750.
b. $4,750.
c. $3,750.
d. $3,250.
e. None of the above.

28. Stan Clark had the following transactions with the Endo Corporation.

Purchase of 1,000 shares of common stock, October 1, 1965	$20,000
Loan to corporation, February 1, 1971	5,000
Purchase of automobile from corporation, fair market value $4,500, March 1, 1973	3,000
Legal advice concerning investment, July 1, 1973	500

The stock became worthless and the loan uncollectible as of December 31, 1973, at which time there was a retained-earnings deficit of $100,000. The corporation sustained a $15,000 operating loss in 1973. Ignoring the dividend exclusion, what is the 1973 tax effect of these transactions to Clark?

a. A long-term capital loss of $23,500 and an itemized deduction of $500.
b. A long-term capital loss of $24,000.
c. A long-term capital loss of $25,000, ordinary income of $1,500, and an itemized deduction of $500.
d. A long-term capital loss of $25,500 and ordinary income of $1,500.
e. None of the above.

29. On November 1, 1958, Sam Lerner leased a building to Kenneth Tate for a period of fifteen years at a monthly rental of $400 with no option to renew. At that date the building had a remaining useful life of twenty years.

Prior to taking possession of the premises, Tate made improvements at a cost of $20,000. These improvements had an estimated useful life of twenty years at the commencement of the lease period. The lease expired on October 31, 1973, at which point the improvements had a fair market value of $3,000. The amount Lerner should include in his 1973 gross income resulting from the leased building is

a. $12,000.
b. $9,000.
c. $7,000.
d. $4,000.
e. None of the above.

30. Dan Paley, Fred Queenan, and Gary Rosen are partners, sharing profits and losses equally. On May 15, 1971, Paley sold land with a cost basis of $22,000 to the partnership at its fair market value of $25,000. On May 1, 1973, Queenan purchased the same land from the partnership for $31,000, its fair market value. The 1973 gain to the partners as a result of the sale to Queenan should be

a. Paley $4,500, Queenan $0, and Rosen $4,500.
b. Paley $3,000, Queenan $0, and Rosen $3,000.
c. Paley $2,000, Queenan $2,000, and Rosen $2,000.
d. Paley $0, Queenan $3,000, and Rosen $3,000.
e. None of the above.

31. Irving Aster, Dennis Brill, and Robert Clark were partners who shared profits and losses equally. On February 28, 1973, Aster sold his interest to Phil Dexter. On March 31, 1973, Brill died, and his estate held his interest for the remainder of the year. The partnership continued to operate and for the fiscal year ending June 30, 1973, it had a profit of $45,000. Assuming that partnership income was earned on a pro rata monthly basis and that all partners were calendar year taxpayers, the distributive shares to be included in 1973 gross income should be

a. Aster $10,000, Brill $0, Estate of Brill $15,000, Clark $15,000, and Dexter $5,000.
b. Aster $10,000, Brill $11,250, Estate of Brill $3,750, Clark $15,000, and Dexter $5,000.
c. Aster $0, Brill $11,250, Estate of Brill $3,750, Clark $15,000, and Dexter $15,000.
d. Aster $0, Brill $0, Estate of Brill $15,000, Clark $15,000, and Dexter $15,000.
e. None of the above.

Number 3 (Estimated time --- 50 to 60 minutes)

The Longhorn Manufacturing Corporation produces only one product, Bevo, and accounts for the production of Bevo using a standard-cost system.

At the end of each year, Longhorn prorates all variances among the various inventories and cost of sales. Because Longhorn prices its inventories on the first-in, first-out basis and all the beginning inventories are used during the year, the variances which had been allocated to the ending inventories are immediately charged to cost of sales at the beginning of the following year. This allows only the current year's variances to be recorded in the variance accounts in any given year.

Following are the standards for the production of one unit of Bevo: 3 units of item A @ $1.00 per unit; 1 unit of item B @ $.50 per unit; 4 units of item C @ $.30 per unit; and 20 minutes of direct labor @ $4.50 per hour. Separate variance accounts are maintained for each type of raw material and for direct labor. Raw material purchases are recorded initially at standard. Manufacturing overhead is applied at $9.00 per actual direct labor hour and is not related to the standard-cost system. There was no overapplied or underapplied manufacturing overhead at December 31, 1972.

After proration of the variances, the various inventories at December 31, 1972, were priced as follows:

Raw Material

Item	*Number of Units*	*Unit Cost*	*Amount*
A	15,000	$1.10	$16,500
B	4,000	.52	2,080
C	20,000	.32	6,400
			$24,980

Work in Process

9,000 units of Bevo which were 100% complete as to items A and B, 50% complete as to item C, and 30% complete as to labor. The composition and valuation of the inventory follows:

Item	*Amount*
A	$28,600
B	4,940
C	6,240
Direct labor	6,175
	45,955
Overhead	11,700
	$57,655

Finished Goods

4,800 units of Bevo composed and valued as follows:

Item	*Amount*
A	$15,180
B	2,704
C	6,368
Direct labor	8,540
	32,792
Overhead	16,200
	$48,992

Following is a schedule of raw materials purchased and direct labor incurred for the year ended December 31,1973. Unit cost of each item of raw material and direct-labor cost per hour remained constant throughout the year.

Purchases

Item	*Number of Units or Hours*	*Unit Cost*	*Amount*
A	290,000	$1.15	$333,500
B	101,000	.55	55,550
C	367,000	.35	128,450
Direct labor	34,100	4.60	156,860

During the year ended December 31, 1973, Longhorn sold 90,000 units of Bevo and had ending physical inventories as follows:

Raw Materials

Item	*Number of Units*
A	28,300
B	2,100
C	28,900

Work in Process

7,500 units of Bevo which were 100% complete as to items A and B, 50% complete as to item C, and 20% complete as to labor, as follows:

Item	*Number of Units or Hours*
A	22,900
B	8,300
C	15,800
Direct labor	800

Finished Goods

5,100 units of Bevo, as follows:

Item	*Number of Units or Hours*
A	15,600
B	6,300
C	21,700
Direct labor	2,050

There was no overapplied or underapplied manufacturing overhead at December 31, 1973.

Required:

Answer each of the following questions. Supporting computations should be prepared in good form.

a. What was the charge or credit to cost of sales at the beginning of 1973 for the variances in the December 31, 1972, inventories?

b. What was the total charge or credit to the three material price-variance accounts for items A, B, and C for the year ended December 31, 1973?

c. What was the total charge or credit to the three material quantity-variance accounts for items A, B, and C for the year ended December 31, 1973?

d. What was the total charge or credit to the direct-labor rate-variance account for the year ended December 31, 1973?

e. What was the total charge or credit to the direct-labor efficiency-variance account for the year ended December 31, 1973?

Number 4 (Estimated time — 50 to 60 minutes)

You have been asked to review and prepare any necessary adjustments for the financial statements of Maneri Electronics, Inc., for the years ended December 31, 1972 and 1973. Maneri received an unqualified opinion on its December 31, 1971, financial statements. You have extracted the following trial balances from the records.

	December 31, 1972 Dr. (Cr.)	*December 31, 1973* Dr. (Cr.)
Cash	$ 62,300	$ 71,297
Accounts receivable – mini calculators	19,500	6,000
Accounts receivable – other	34,300	45,299
Inventory – mini calculators	7,500	27,500
Inventory – other	89,500	92,019
Work-in-process inventory	7,307	9,409
6.5% note receivable	10,000	10,000
Building	257,220	257,220
Other assets	46,539	47,379
Other liabilities	(128,863)	(143,146)
6.5% construction loan	(168,000)	–
6.5% mortgage payable	–	(156,000)
Common stock	(185,000)	(185,000)
Retained earnings	(65,012)	(52,303)
Sales – mini calculators	(60,000)	–
Sales – other	(293,814)	(323,111)
Service department fees for computer-X	(7,200)	(9,612)
Cost of sales – mini calculators	40,000	–
Cost of sales – other	196,000	206,000
Interest income on 6.5% note receivable	–	(650)
Interest on construction loan	11,700	–
Interest on mortgage	–	10,920
Life insurance expense	–	2,500
Other expenses	126,023	84,279
	$ 0	$ 0

As a result of your investigation you have developed the following information.

1. On July 1, 1973, Maneri contracted for a permanent-type, $50,000 mutual life insurance policy on the life of its president. Maneri designated itself as beneficiary. The annual gross premium of $2,500 is due on the contract date and thereafter on the annual anniversary date. The policy estimates that a dividend of $350 will be due the policyholder on July 1, 1974, and stipulates that the cash surrender value of the policy will be $84 on July 1, 1974. Maneri has elected to offset policy dividends against future premiums.

2. In 1972 Maneri manufactured a new mini calculator. The marketing plan includes shipping the units on consignment to certain retailers. The following facts are available:

	1972	1973
Units produced (at $100 per unit)	475	200
Units shipped on consignment	400	–
Unit sales reported by consignees (at $150 per unit)	300	100

Retailers are entitled to deduct 10% of the sales price as a commission. All consignees' reports were accompanied by full remittances.

3. An invoice dated December 29, 1972, for a purchase of raw-materials (other) inventory for $4,105 was recorded in January 1973. The material was included in the December 31, 1972, count of physical inventory.

4. Maneri services computer-X electronic equipment on a contract basis. The service fee is payable one year in advance. Maintenance is generally performed ratably over the life of the contract. Maneri recorded the following 12-month contracts as revenue when cash was received:

Date of Contracts	*Amount*
April 1, 1972	$7,200
August 1, 1973	$9,612

5. The note receivable due December 31, 1975, was issued on January 2, 1972. Interest is due annually on January 2. The prevailing interest rate on similar notes is 6.5%.

6. An analysis of the building account follows.

Purchase price of land and building	$ 55,000
Unpaid taxes assumed	4,300
Cost of demolition of old building	4,110
Cost of subdividing land	510
Payment to tenants of old building to cancel leases	3,300
Construction of new building	190,000
	$257,220

On January 3, 1972, Maneri purchased an old building on ten acres of land for $55,000 cash. The company immediately began demolition of the building and subdivision of the land into ten, one-acre lots of equal value. Nine acres were held for speculation and the other acre was used for construction of a new office building which was begun on January 3, 1972.

To finance the construction, Maneri obtained $180,000 proceeds of a one-year, 6.5% construction loan on January 3, 1972. The prevailing interest rate on similar loans was 6.5%. A payment of $12,000 principle plus interest was made on December 29, 1972. The unpaid balance of $168,000 was converted to a 6.5%, fourteen-year mortgage note on January 3, 1973. Note payments are due in equal installments plus interest annually on December 31. The note is secured by the building and the one acre of land on which it resides.

Construction of the new building was completed on December 30, 1972. Maneri occupied the building on January 3, 1973. The building has an estimated life of forty years and a salvage value of $5,000; depreciation is to be computed on a straight-line basis. Depreciation has not been recorded.

7. Maneri distributes Super-D AM-FM radios to retailers. The radios are shipped from Maneri's supplier-manufacturer directly to the retailers. Maneri does not maintain an inventory of the radios.

In January 1972 Maneri signed a three-year contract to purchase 2,100 Super-D AM-FM radios each year from Melgren Manufacturing Company at a firm price of $30 per unit.

During January 1973, due to improvements in the production process, all local manufacturers of radios similar to the Super-D radio lowered their price to $22 per unit. Melgren also reduced its price of the Super-D radio to $22 except to Maneri. For competitive reasons, comparable reductions in prices to retailers were made by all local distributors including Maneri. Due to a long-time business relationship between Melgren and Maneri, and the certainty of future business, Maneri considers its contract with Melgren binding and will not contest it. Maneri purchased 2,300 radios in 1972, 2,100 in 1973, and intends to meet its purchase commitment of 2,100 units in 1974.

Required:

Prepare a schedule of adjustments which must be made to correct the 1972 and 1973 trial balances. The items on the schedule should be presented in the same order as the facts are given with corresponding numbers 1 through 7. Include supporting data for item 6. Adjusted trial balances and formal financial statements are not required. **Ignore income tax and deferred tax considerations.** Use the following columnar headings for your schedule.

		1972			*1973*		
No.	*Explanation*	*Income Statement Dr. (Cr.)*	*Balance Sheet Dr. (Cr.)*	*Account*	*Income Statement Dr. (Cr.)*	*Balance Sheet Dr. (Cr.)*	*Account*

Number 5 (Estimated time — 40 to 50 minutes)

The following transactions represent practical situations frequently encountered in accounting for municipal governments. Each transaction is independent of the others.

1. The city council of Bernardville adopted a budget for the general operations of the government during the new fiscal year. Revenues were estimated at $695,000. Legal authorizations for budgeted expenditures were $650,000.

2. Taxes of $160,000 were levied for the special revenue fund of Millstown. One percent was estimated to be uncollectible.

3. a. On July 25, 1973, office supplies estimated to cost $2,390 were ordered for the city manager's office of Bullersville. Bullersville, which operates on the calendar year, does not maintain an inventory of such supplies.

   b. The supplies ordered July 25 were received on August 9, 1973, accompanied by an invoice for $2,500.

4. On October 10, 1973, the general fund of Washingtonville repaid to the utility fund a loan of $1,000 plus $40 interest. The loan had been made earlier in the fiscal year.

5. A prominent citizen died and left ten acres of undeveloped land to Harper City for a future school site. The donor's cost of the land was $55,000. The fair value of the land was $85,000.

6. a. On March 6, 1973, Dahlstrom City issued 4% special assessment bonds payable March 6, 1978, at face value of $90,000. Interest is payable annually. Dahlstrom City, which operates on the calendar year, will use the proceeds to finance a curbing project.

   b. On October 29, 1973, the full $84,000 cost of the completed curbing project was accrued. Also, appropriate closing entries were made with regard to the project.

7. a. Conrad Thamm, a citizen of Basking Knoll, donated common stock valued at $22,000 to the city under a trust agreement. Under the terms of the agreement, the principal amount is to be kept intact; use of revenue from the stock is restricted to financing academic college scholarships for needy students.

   b. On December 14, 1973, dividends of $1,100 were received on the stock donated by Mr. Thamm.

8. a. On February 23, 1973, the town of Lincoln, which operates on the calendar year, issued 4% general obligation bonds with a face value of $300,000 payable February 23, 1983, to finance the construction of an addition to the city hall. Total proceeds were $308,000.

   b. On December 31, 1973, the addition to the city hall was officially approved, the full cost of $297,000 was paid to the contractor, and appropriate closing entries were made with regard to the project. (Assume that no entries have been made with regard to the project since February 23, 1973.)

Required:

For each transaction, prepare the necessary journal entries for **all** of the funds and groups of accounts involved. **No explanation of the journal entries is required.** Use the following headings for your workpaper:

Transaction Number	*Journal Entries*	*Dr.*	*Cr.*	*Fund or Group of Accounts*

In the far right column, indicate in which fund or group of accounts each entry is to be made, using the coding below:

Funds:	
General	G
Special revenue	SR
Capital projects	CP
Debt service	DS
Special assessments	SA
Enterprise	E
Intragovernmental service	IS
Trust and agency	TA
Groups of accounts:	
General fixed assets	GFA
General long-term debt	LTD

Uniform Certified Public Accountant Examination

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN AUDITING

May 9, 1974; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	30	40
No. 2	30	40
No. 3	20	26
No. 4	20	26
No. 5	20	26
No. 6	20	26
No. 7	20	26
Total for examination	160	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time –– 30 to 40 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

96. One of the generally accepted auditing standards specifies that the auditor
   a. Inspect all fixed assets acquired during the year.
   b. Charge fair fees based on cost.
   c. Make a proper study and evaluation of the existing internal control.
   d. May **not** solicit clients.

Answer Sheet

96. a. :::::::::: b. :::::::::: c. ▬▬ d. ::::::::::

Items to be Answered

1. A certified public accountant may be retained by his client to perform routine bookkeeping services or to prepare financial statements for the client's internal use only. For such statements, it might **not** be necessary to include all footnotes or other disclosures that otherwise would be desirable. In this situation
   a. A disclaimer of opinion is **not** required.
   b. The CPA should add to his disclaimer of opinion a sentence to the effect that the financial statements are restricted to internal use by the client and therefore do **not** necessarily include all disclosures that might be required for a fair presentation.
   c. A disclaimer of opinion is required, and the CPA should include all informative disclosures considered necessary in the circumstances.
   d. An adverse opinion is required.

2. When a certified public accountant who is **not** independent is associated with financial statements, he would be precluded from expressing an opinion because
   a. The public would be aware of his lack of independence and would place little or **no** faith in his opinion.
   b. He would place himself in the position of suffering an adverse decision in a possible liability suit.
   c. He would be in the position of auditing his own work.
   d. Any auditing procedures he might perform would **not** be in accordance with generally accepted auditing standards.

3. When a CPA has concluded that action should be taken to prevent future reliance on his report, he should
   a. Advise his client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to persons who are known to be currently relying or who are likely to rely on the financial statements and the related auditor's report.
   b. Recall the financial statements and issue revised statements and include an appropriate opinion.
   c. Advise the client and others **not** to rely on the financial statements and make appropriate disclosure of the correction in the statements of a subsequent period.
   d. Recall the financial statements and issue a disclaimer of opinion which should generally be followed by revised statements and a qualified opinion.

4. The use of the positive (as opposed to the negative) form of receivables confirmation is indicated when
   a. Internal control surrounding accounts receivable is considered to be effective.
   b. There is reason to believe that a substantial number of accounts may be in dispute.
   c. A large number of small balances are involved.
   d. There is reason to believe a significant portion of the requests will be answered.

5. If statistical-sampling methods are used by a client in the taking of its physical inventory, the CPA must
   a. Insist that the client take a complete physical inventory at least once each year and observe the inventory count if it is reasonable and practicable for him to do so.
   b. Observe such test counts as he deems necessary and satisfy himself that the sampling plan has statistical validity, that it was properly applied, and that the resulting precision and reliability are reasonable in the circumstances.
   c. Either observe a complete inventory count sometime during the year and satisfy himself that the statistical procedures are valid or qualify or disclaim an opinion on the financial statements taken as a whole.
   d. Either observe a statistical inventory count each year or qualify or disclaim an opinion on the financial statements taken as a whole.

6. The auditor should be concerned about internal control in a data processing system because
   a. The auditor **cannot** follow the flow of information through the computer.
   b. Fraud is more common in an EDP system than a manual system.
   c. There is usually a high concentration of data processing activity and control in a small number of people in an EDP system.
   d. Auditors most often "audit around the computer."

7. A CPA has **not** been able to confirm a large account receivable, but he has satisfied himself as to the proper statement of the receivable by means of alternative auditing procedures. The auditor's report on the financial statements should include
   a. A description of the limitation on the scope of his examination and the alternative auditing procedures used, but an opinion qualification is **not** required.
   b. An opinion qualification, but reference to the use of alternative auditing procedures is **not** required.
   c. Both a scope qualification and an opinion qualification.
   d. Neither a comment on the use of alternative auditing procedures nor an opinion qualification.

8. The primary responsibility for the adequacy of disclosure in the financial statements and footnotes rests with the
   a. Partner assigned to the engagement.
   b. Auditor in charge of field work.
   c. Staffman who drafts the statements and footnotes.
   d. Client.

Items 9 and 10 are based on the following information:

Once an auditor has determined that an exception is material enough to warrant qualification of his auditor's report, he must then determine if the exception is sufficiently material to negate an overall opinion.

9. If an auditor is applying this decision process to an exception based on a departure from generally accepted accounting principles, he is deciding
   a. Whether to issue an adverse opinion rather than a "subject to" opinion.
   b. Whether to issue a disclaimer of opinion rather than a "subject to" opinion.
   c. Whether to issue an adverse opinion rather than an "except for" opinion.
   d. Nothing because this decision process is **not** applicable to this type of exception.

10. If an auditor is applying this decision process to a consistency exception, he is deciding
   a. Whether to issue a disclaimer of opinion rather than an "except for" opinion.
   b. Whether to issue a disclaimer of opinion rather than a "subject to" opinion.
   c. Whether to issue an adverse opinion rather than an "except for" opinion.
   d. Nothing because this decision process is **not** applicable to this type of exception.

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11. When auditing a computerized system, an auditor may use the "integrated test facility" technique, sometimes referred to as the mini-company approach, as an audit tool. This technique
   a. Is more applicable to independent audits than internal audits.
   b. Involves using test decks.
   c. Is the most commonly used audit tool for "auditing through the computer."
   d. Involves introducing simulated transactions into a system simultaneously with actual transactions.

12. Carolyn Burns, CPA, has been assisting Nestler Manufacturing Corporation in the preparation of unaudited financial statements. It has come to the attention of Burns that Nestler is carrying a substantial investment in Salvemini, Inc., at cost, even though it is public knowledge that Salvemini is in bankruptcy and its stock is worthless. Burns' reporting responsibility is met by
   a. Describing the deviation from generally accepted accounting principles in her disclaimer of opinion.
   b. Issuing an adverse opinion.
   c. Issuing the statements on plain paper without reference to Burns.
   d. Stating in her disclaimer of opinion that Nestler's financial statements are unaudited.

13. In reporting on the consolidated financial statements of a parent company and its subsidiaries, if the principal auditor decides to assume responsibility for the work of another CPA insofar as the other CPA's work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole, the principal auditor should
   a. Make reference in his auditor's report to the other CPA's examination.
   b. **Not** make reference to the other CPA's examination.
   c. Make reference in his auditor's report to the other CPA's examination and responsibility and include the report of the other CPA.
   d. **Not** make reference to the other CPA's examination, but he should include the other CPA's report.

14. During the year ended December 31, 1973, Yolly Corporation had its fixed assets appraised and found that they had substantially appreciated in value since the date of their purchase. The appraised values have been reported in the balance sheet as of December 31, 1973; the total appraisal increment has been included as an extraordinary item in the income statement for the year then ended; and the appraisal adjustment has been fully disclosed in the footnotes. If a CPA believes that the values reported in the financial statements are reasonable, what type of opinion should he issue?
   a. An unqualified opinion.
   b. A "subject to" qualified opinion.
   c. An adverse opinion.
   d. A disclaimer of opinion.

15. A magnetic tape header label is used to warn the operator that
   a. The next processing step is about to begin.
   b. A wrong input tape has been mounted.
   c. An incorrect number of records have been processed.
   d. A different type of input or output device must be used.

Items 16 through 20 apply to an examination by Robert Lambert, CPA, of the financial statements of Rainbow Manufacturing Corporation for the year ended December 31, 1973. Rainbow manufactures two products: Product A and Product B. Product A requires raw materials which have a very low per-item cost, and Product B requires raw materials which have a very high per-item cost. Raw materials for both products are stored in a single warehouse. In 1972 Rainbow established the total value of raw materials stored in the warehouse by physically inventorying an unrestricted random sample of items selected without replacement.

Mr. Lambert is evaluating the statistical validity of alternative sampling plans Rainbow is considering for 1973. Lambert knows the size of the 1972 sample and that Rainbow did **not** use stratified sampling in 1972. Assumptions about the population, variability, specified precision (confidence interval), and specified reliability (confidence level) for a possible 1973 sample are given in each of the following five items. You are to indicate in each case the effect upon the size of the 1973 sample as compared to the 1972 sample. Each of the five cases is independent of the other four and is to be considered separately. **Your answer choice for each item 16 through 20 should be selected from the following responses:**
   a. Larger than the 1972 sample size.
   b. Equal to the 1972 sample size.
   c. Smaller than the 1972 sample size.
   d. Of a size that is indeterminate based upon the information given.

16. Rainbow wants to use stratified sampling in 1973 (the total population will be divided into two strata, one each for the raw materials for Product A and Product B). Compared to 1972, the population size of the raw-materials inventory is approximately the same, and the variability of the items in the inventory is approximately the same. The specified precision and specified reliability are to remain the same.

Under these assumptions, the required sample size for 1973 should be
   a. Larger than the 1972 sample size.
   b. Equal to the 1972 sample size.
   c. Smaller than the 1972 sample size.
   d. Of a size that is indeterminate based upon the information given.

17. Rainbow wants to use stratified sampling in 1973. Compared to 1972, the population size of the raw-materials inventory is approximately the same, and the variability of the items in the inventory is approximately the same. Rainbow specified the same precision but desires to change the specified reliability from 90% to 95%.

Under these assumptions, the required sample size for 1973 should be
   a. Larger than the 1972 sample size.
   b. Equal to the 1972 sample size.
   c. Smaller than the 1972 sample size.
   d. Of a size that is indeterminate based upon the information given.

18. Rainbow wants to use unrestricted random sampling without replacement in 1973. Compared to 1972, the population size of the raw-materials inventory is approximately the same, and the variability of the items in the inventory is approximately the same. Rainbow specifies the same precision but desires to change the specified reliability from 90% to 95%.

Under these assumptions, the required sample size for 1973 should be
   a. Larger than the 1972 sample size.
   b. Equal to the 1972 sample size.
   c. Smaller than the 1972 sample size.
   d. Of a size that is indeterminate based upon the information given.

19. Rainbow wants to use unrestricted random sampling without replacement in 1973. Compared to 1972, the population size of the raw-materials inventory has increased, and the variability of the items in the inventory has increased. The specified precision and specified reliability are to remain the same.

Under these assumptions, the required sample size for 1973 should be
   a. Larger than the 1972 sample size.
   b. Equal to the 1972 sample size.
   c. Smaller than the 1972 sample size.
   d. Of a size that is indeterminate based upon the information given.

20. Rainbow wants to use unrestricted random sampling without replacement in 1973. Compared to 1972, the population size of the raw-materials inventory has increased, but the variability of the items in the inventory has decreased. The specified precision and specified reliability are to remain the same.

Under these assumptions, the required sample size for 1973 should be
   a. Larger than the 1972 sample size.
   b. Equal to the 1972 sample size.
   c. Smaller than the 1972 sample size.
   d. Of a size that is indeterminate based upon the information given.

21. If a prior year's financial statements are presented in comparison with the current year's financial statements and are **not** restated to give appropriate recognition to a pooling of interests which occurred during the current year, the CPA should
   a. Qualify his opinion as to consistency.
   b. Qualify his opinion as to departure from generally accepted accounting principles.
   c. Qualify his opinion as to consistency and departure from generally accepted accounting principles.
   d. Disclaim an opinion.

22. Control totals are used as a basic method for detecting data errors. Which of the following is **not** a control figure used as a control total in EDP systems?
   a. Ledger totals.
   b. Check-digit totals.
   c. Hash totals.
   d. Document-count totals.

23. General and special computer programs have been developed for use in auditing EDP systems. When considering the use of these computer-audit programs, the auditor
   a. Should determine the audit efficiency of using a given computer program.
   b. Will find them ineffective for applications containing many records and requiring significant time for testing.
   c. Should use them on a surprise basis in order for them to be effective.
   d. Will find them economically feasible for any size EDP system.

24. The Smith Corporation has numerous small customers. A customer file is kept on disk storage. For each customer the file contains customer name, address, credit limit, and account balance. The auditor wishes to test this file to determine whether credit limits are being exceeded. Assuming that computer time is available, the best procedure for the auditor to follow would be to
   a. Develop a test deck which would cause the account balance of certain accounts to be increased until the credit limit was exceeded to see if the system would react properly.
   b. Develop a program to compare credit limits with account balances and print out the details of any account with a balance exceeding its credit limit.
   c. Ask for a printout of all account balances so that they can be manually checked against the credit limits.
   d. Ask for a printout of a sample of account balances so that they can be individually checked against the credit limits.

25. In the report of the principal auditor, reference to the fact that part of the examination was made by another auditor is
   a. **Not** to be construed as a qualification of the opinion but rather as an indication of the divided responsibility.
   b. **Not** in accordance with generally accepted auditing standards.
   c. A special kind of qualified opinion resulting from the divided responsibility.
   d. An example of a dual opinion requiring the signature of both auditors.

Number 2 (Estimated time — 30 to 40 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

26. Bell's accounts-payable clerk has a brother who is one of Bell's vendors. The brother will often invoice Bell twice for the same delivery. The accounts-payable clerk removes the receiving report for the first invoice from the paid-voucher file and uses it for support of payment for the duplicate invoice. The most effective procedure for preventing this activity is to
   a. Use prenumbered receiving reports.
   b. Mail signed checks without allowing them to be returned to the accounts-payable clerk.
   c. Cancel vouchers and supporting papers when payment is made.
   d. Use dual signatures.

27. Tedori Manufacturing Company received a substantial sales return on December 30, 1973, but the credit memorandum for the return was not prepared and recorded until March 4, 1974. The returned merchandise was included in the year-end physical inventory taken on December 31, 1973. The most effective procedure for preventing this type of error is to
   a. Prepare an aged schedule of accounts receivable monthly.
   b. Prenumber and account for all credit memorandums.
   c. Reconcile the subsidiary accounts-receivable ledger with the general-ledger control account monthly.
   d. Prepare and numerically control receiving reports for all materials received.

28. Smith Manufacturing Company's accounts-receivable clerk has a friend who is also Smith's customer. The accounts-receivable clerk, on occasion, has issued fictitious credit memorandums to his friend for goods supposedly returned. The most effective procedure for preventing this activity is to

a. Prenumber and account for all credit memorandums.
b. Require receiving reports to support all credit memorandums before they are approved.
c. Have the sales department independent of the accounts-receivable department.
d. Mail monthly statements.

29. Which of the following is a responsibility that should **not** be assigned to only one employee?

a. Access to securities in the company's safe deposit box.
b. Custodianship of the cash working fund.
c. Reconciliation of bank statements.
d. Custodianship of tools and small equipment.

30. Salesmen's commissions are based on gross sales. Sales continue to increase; but uncollectible accounts receivable are also increasing at an alarming rate. The most effective procedure for preventing the increase in uncollectible accounts receivable is to

a. Have the sales manager review activity of individual salesmen.
b. Age accounts receivable regularly.
c. Have the write-off of accounts properly approved.
d. Have the credit department approve credit extended to customers before shipment.

31. The major reason an independent auditor gathers audit evidence is to

a. Form an opinion on the financial statements.
b. Detect fraud.
c. Evaluate management.
d. Evaluate internal control.

32. Jefferson, CPA, has prepared Mr. Burr's federal income tax return for several years. This year Jefferson had discovered that in the prior years's return he made an error that resulted in a lower tax liability for Burr. The tax return is now under IRS administrative review. What are Jefferson's professional responsibilities in this connection?

a. Jefferson should inform Burr of the error and seek his agreement to disclose it promptly to IRS officials.
b. Jefferson should maintain the confidentiality of information obtained in the course of a professional engagement even if questioned in Tax Court.
c. Jefferson should disclose the error to IRS officials promptly, either orally or in writing.
d. Jefferson should terminate his accountant-client relationship with Burr upon discovery of the error.

33. A factory foreman at Steblecki Corporation discharged an hourly worker but did **not** notify the payroll department. The foreman then forged the worker's signature on time cards and work tickets and, when giving out the checks, diverted the payroll checks drawn for the discharged worker to his own use. The most effective procedure for preventing this activity is to

a. Require written authorization for all employees added to or removed from the payroll.
b. Have a paymaster who has **no** other payroll responsibility distribute the payroll checks.
c. Have someone other than persons who prepare or distribute the payroll obtain custody of unclaimed payroll checks.
d. From time to time, rotate persons distributing the payroll.

34. Under the AICPA Code of Professional Ethics, which of the following may a practicing CPA do in connection with educational seminars?

a. Send announcements about his appearance on a seminar program to nonclients or invite them to attend.
b. Sponsor a seminar and send invitations to nonclients.
c. Allow himself to be listed as a tax expert on the seminar announcement.
d. Distribute firm literature at the seminar to nonclients on a relevant topic being discussed at the seminar.

35. Murphy & Co., CPAs, is the principal auditor of the consolidated financial statements of Lowe, Inc., and subsidiaries. Lowe accounts for approximately 98% of consolidated assets and consolidated net income. The two subsidiaries are audited by Trotman & Co., CPAs, a firm with an excellent professional reputation. Murphy insists on auditing the two subsidiaries because it deems this necessary to warrant the expression of an opinion.

a. The principal auditor of consolidated statements may never insist on auditing the subsidiaries.
b. Murphy may insist on auditing the subsidiaries only if it shares the fee with Trotman.
c. Murphy may insist on auditing the subsidiaries only if it can show that total fees will be reduced.
d. Murphy may be considered in violation of the AICPA Code of Professional Ethics because of encroachment on Trotman.

36. Parnell, CPA, accepted the audit engagement of Treacy Manufacturing, Inc. During the audit, Parnell became aware of the fact that he did **not** have the competence required for the engagement. What should Parnell do?

a. Disclaim an opinion.
b. Issue a "subject to" opinion.
c. Suggest that Treacy engage another CPA to perform the audit.
d. Rely on the competence of client personnel.

37. A bank issued a notice to its depositors that it was being audited and requested them to comply with the CPA's efforts to obtain confirmation of the deposit balances. The bank printed the name and address of the CPA in the notice. The CPA had knowledge of the mailing.

a. The CPA violated the AICPA Code of Professional Ethics because this was a form of advertising.
b. The CPA violated the AICPA Code of Professional Ethics because this notice would cause confirmation results to be unusually high and, therefore, could **not** be compared to prior-period returns.
c. The CPA violated the AICPA Code of Professional Ethics because the bank's depositors may include clients of other CPAs and this would be a form of solicitation.
d. The CPA did **not** violate the AICPA Code of Professional Ethics.

38. The AICPA Code of Professional Ethics derives its authority from the

a. Bylaws of the American Institute of CPAs.
b. Financial Accounting Standards Board.
c. Federal government.
d. Securities and Exchange Commission.

39. Barnes, CPA, has an audit client, Smith, Inc., which uses another CPA for management-services work. Barnes sends his firm's literature covering its management-services capabilities to Smith on a monthly unsolicited basis.

a. Barnes is violating the AICPA Code of Professional Ethics because this is a form of advertising.
b. Barnes is violating the AICPA Code of Professional Ethics unless he obtains the other CPA's permission to mail such literature to Smith.
c. Barnes is violating the AICPA Code of Professional Ethics because this is considered encroachment.
d. Barnes is **not** violating the AICPA Code of Professional Ethics.

40. Evidential matter is generally considered sufficient when

a. It is competent.
b. There is enough of it to afford a reasonable basis for an opinion on financial statements.
c. It has the qualities of being relevant, objective, and free from unknown bias.
d. It has been obtained by random selection.

41. When evaluating internal control, the auditor's primary concern is to determine

a. The possibility of fraud occurring.
b. Compliance with policies, plans, and procedures.
c. The reliability of the accounting information system.
d. The type of an opinion he will issue.

42. When an auditor issues a qualified opinion because of an uncertainty, the reader of the auditor's report should conclude that

a. The auditor was **not** able to form an opinion on the financial statements taken as a whole.
b. The uncertainty occurred after the balance-sheet date but prior to the audit-report date.
c. There were **no** audit procedures feasibly available to the auditor by which he could obtain satisfaction concerning the uncertainty.
d. The ability of the company to continue as a "going concern" is questionable.

43. Ball Company, which has **no** perpetual inventory records, takes a monthly physical inventory and reorders any item which is less than its reorder point. On February 5, 1973, Ball ordered 5,000 units of item A. On February 6, 1973, Ball received 5,000 units of item A which had been ordered on January 3, 1973. To prevent this excess ordering, Ball should

a. Keep an adequate record of open purchase orders and review it before ordering.
b. Use perpetual inventory records which indicate goods received, issued, and amounts on hand.
c. Use prenumbered purchase orders.
d. Prepare purchase orders only on the basis of purchase requisitions.

44. A sales clerk at Schackne Company correctly prepared a sales invoice for $5,200, but the invoice was entered as $2,500 in the sales journal and similarly posted to the general ledger and accounts-receivable ledger. The customer remitted only $2,500, the amount on his monthly statement. The most effective procedure for preventing this type of error is to

a. Use predetermined totals to control posting routines.
b. Have an independent check of sales-invoice serial numbers, prices, discounts, extensions, and footings.
c. Have the bookkeeper prepare monthly statements which are verified and mailed by a responsible person other than the bookkeeper.
d. Have a responsible person who is independent of the accounts-receivable department promptly investigate unauthorized remittance deductions made by customers or other matters in dispute.

45. In evaluating internal control, the first step is to prepare an internal-control questionnaire or a flow chart of the system. The second step should be to

a. Determine the extent of audit work necessary to form an opinion.
b. Gather enough evidence to determine if the internal-control system is functioning as described.
c. Write a letter to management describing the weaknesses in the internal-control system.
d. Form a final judgment on the effectiveness of the internal-control system.

46. Smith, CPA, issued an "except for" opinion on the financial statements of Wald Company for the year ended December 31, 1973. Wald has engaged another firm of CPAs to make a second audit. The local bank has knowledge of Smith's audit and has asked Smith to explain why the financial statements and his opinion have **not** been made available.
   a. Smith **cannot** provide the bank with information about Wald under any circumstances.
   b. If Wald consents, Smith may provide the bank with information concerning Wald.
   c. If the other firm of CPAs consents, Smith may provide the bank with information concerning Wald.
   d. The only way the bank can obtain information concerning Smith's audit is to obtain it by subpoena.

47. Under the AICPA Code of Professional Ethics which of the following characteristics is true for a professional corporation or association of CPAs?
   a. The name may be impersonal as long as it does **not** indicate a speciality.
   b. The shareholders must, in all cases, be jointly and severally liable for the acts of the corporation.
   c. The corporation may provide services that are **not** compatible with the practice of public accounting.
   d. A shareholder who ceases to be eligible to be a shareholder must dispose of all of his shares within a reasonable period.

48. The most reliable type of documentary audit evidence that an auditor can obtain is
   a. Physical examination by the auditor.
   b. Documentary evidence calculated by the auditor from company records.
   c. Confirmations received directly from third parties.
   d. Internal documents.

49. Theoretically, which of the following would **not** have an effect on the amount of audit evidence gathered by the auditor?
   a. The type of opinion to be issued.
   b. The auditor's evaluation of internal control.
   c. The types of audit evidence available to the auditor.
   d. Whether or **not** the client reports to the Securities and Exchange Commission.

50. The strongest criticism of the reliability of audit evidence which the auditor physically observes is that
   a. The client may conceal items from the auditor.
   b. The auditor may **not** be qualified to evaluate the items which he is observing.
   c. Such evidence is too costly in relation to its reliability.
   d. The observation must occur at a specific time, which is often difficult to arrange.

Number 3 (Estimated time –– 20 to 26 minutes)

You are the in-charge accountant examining the financial statements of the Gutzler Company for the year ended December 31, 1973. During late October 1973, you, with the help of Gutzler's controller, completed an internal control questionnaire and prepared the appropriate memorandums describing Gutzler's accounting procedures. Your comments relative to cash receipts are as follows.

All cash receipts are sent directly to the accounts-receivable clerk with no processing by the mail department. The accounts-receivable clerk keeps the cash-receipts journal; prepares the bank-deposit slip in duplicate; posts from the deposit slip to the subsidiary accounts-receivable ledger; and mails the deposit to the bank.

The controller receives the validated deposit slips directly (unopened) from the bank. He also receives the monthly bank statement directly (unopened) from the bank and promptly reconciles it.

At the end of each month, the accounts-receivable clerk notifies the general-ledger clerk by journal voucher of the monthly totals of the cash-receipts journal for posting to the general ledger.

Each month, with regard to the general-ledger cash account, the general-ledger clerk makes an entry to record the total debits to cash from the cash-receipts journal. In addition, the general-ledger clerk on occasion makes debit entries in the general-ledger cash account from sources other than the cash-receipts journal, e.g., funds borrowed from the bank.

Certain standard auditing procedures which are listed in the next column have already been performed by you in the audit of cash receipts. The extent to which these procedures were performed is **not** relevant to the question.

- Total and cross-total all columns in the cash-receipts journal.
- Trace postings from the cash-receipts journal to the general ledger.
- Examine remittance advices and related correspondence to support entries in the cash-receipts journal.

Required:

Considering Gutzler's internal control over cash receipts and standard auditing procedures already performed, list all other auditing procedures and reasons therefor which should be performed to obtain sufficient audit evidence regarding cash receipts. **Do not discuss the procedures for cash disbursements and cash balances. Also do not discuss the extent to which any of the procedures are to be performed. Assume adequate controls exist to assure that all sales transactions are recorded.** Organize your answer sheet as follows:

Other audit procedures	*Reason for other audit procedures*

Number 4 (Estimated time -- 20 to 26 minutes)

Charles Burke, CPA, has completed field work for his examination of the Willingham Corporation for the year ended December 31, 1973, and now is in the process of determining whether to modify his report. Presented below are two, independent, unrelated situations which have arisen.

Situation I

In September 1973, a lawsuit was filed against Willingham to have the court order it to install pollution-control equipment in one of its older plants. Willingham's legal counsel has informed Burke that it is not possible to forecast the outcome of this litigation; however, Willingham's management has informed Burke that the cost of the pollution-control equipment is not economically feasible and that the plant will be closed if the case is lost. In addition, Burke has been told by management that the plant and its production equipment would have only minimal resale values and that the production that would be lost could not be recovered at other plants.

Situation II

During 1973, Willingham purchased a franchise amounting to 20% of its assets for the exclusive right to produce and sell a newly patented product in the northeastern United States. There has been no production in marketable quantities of the product anywhere to date. Neither the franchisor nor any franchisee has conducted any market research with respect to the product.

Required:

In deciding the type-of-report modification, if any, Burke should take into account such considerations as follows:

- Relative magnitude
- Uncertainty of outcome
- Likelihood of error
- Expertise of the auditor
- Pervasive impact on the financial statements
- Inherent importance of the item

Discuss Burke's type-of-report decision for each situation in terms of the above and other appropriate considerations. Assume each situation is adequately disclosed in the notes to the financial statements. Each situation should be considered independently. In discussing each situation, ignore the other. **It is not necessary for you to decide the type of report which should be issued.**

Number 5 (Estimated time -- 20 to 26 minutes)

As part of your annual audit of Call Camper Company, you have the responsibility for preparing a report on internal control to management. Your workpapers include a completed internal-control questionnaire and documentation of other tests of the internal-control system which you have reviewed. This review identified a number of material weaknesses; for some of these corrective action by management is not practicable in the circumstances.

Required:

a. Discuss the form and content of the report on internal control to management based on your annual audit and the reasons or purposes for such a report. **Do not write a report.**

b. Discuss the differences in the form and content of the report if it were based on a special study for the purpose of reporting to a regulatory agency.

Number 6 (Estimated time –– 20 to 26 minutes)

In late spring of 1974 you are advised of a new assignment as in-charge accountant of your CPA firm's recurring annual audit of a major client, the Lancer Company. You are given the engagement letter for the audit covering the calendar year December 31, 1974, and a list of personnel assigned to this engagement. It is your responsibility to plan and supervise the field work for the engagement.

Required:

Discuss the necessary preparation and planning for the Lancer Company annual audit **prior to** beginning field work at the client's office. In your discussion include the sources you should consult, the type of information you should seek, the preliminary plans and preparation you should make for the field work and any actions you should take relative to the staff assigned to the engagement. **Do not write an audit program.**

Number 7 (Estimated time –– 20 to 26 minutes)

Presented below are three independent, unrelated auditor's reports. The corporation being reported on, in each case, is profit oriented and publishes general-purpose financial statements for distribution to owners, creditors, potential investors, and the general public. Each of the following reports contains deficiencies.

Auditor's Report I

We have examined the consolidated balance sheet of Belasco Corporation and subsidiaries as of December 31, 1973, and the related consolidated statements of income and retained earnings and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We did not examine the financial statements of Seidel Company, a major consolidated subsidiary. These statements were examined by other auditors whose report thereon has been furnished to us, and our opinion expressed herein, insofar as it relates to Seidel Company, is based solely upon the report of the other auditors.

In our opinion, except for the report of the other auditors, the accompanying consolidated balance sheet and consolidated statements of income and retained earnings and changes in financial position present fairly the financial position of Belasco Corporation and subsidiaries at December 31, 1973, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Auditor's Report II

The accompanying balance sheet of Jones Corporation as of December 31, 1973, and the related statements of income and retained earnings and changes in financial position for the year then ended were not audited by us; however, we confirmed cash in the bank and performed a general review of the statements.

During our engagement, nothing came to our attention to indicate that the aforementioned financial statements do not present fairly the financial position of Jones Corporation at December 31, 1973, and the results of its operations and the changes in its financial position for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year; however, we do not express an opinion on them.

Auditor's Report III

I made my examination in accordance with generally accepted auditing standards. However, I am not independent with respect to Mavis Corporation because my wife owns 5% of the outstanding common stock of the company. The accompanying balance sheet as of December 31, 1973, and the related statements of income and retained earnings and changes in financial position for the year then ended were not audited by me; accordingly, I do not express an opinion on them.

Required:

For each auditor's report describe the reporting deficiencies, explain the reasons therefor, and briefly discuss how the report should be corrected. Each report should be considered separately. When discussing one report, ignore the other two. **Do not discuss the addressee, signatures, and date. Also do not rewrite any of the auditor's reports.** Organize your answer sheet as follows:

Report No.	*Deficiency*	*Reason*	*Correction*

Uniform Certified Public Accountant Examination

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN BUSINESS LAW

(Commercial Law)

May 10, 1974; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required	Estimated Minutes Minimum	Estimated Minutes Maximum
No. 1	25	30
No. 2	25	30
No. 3	25	30
No. 4	25	30
No. 5	25	30
No. 6	25	30
No. 7	25	30
Total for examination	175	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered from 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time –– 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The text of a letter from Bridge Builders, Inc., to Allied Steel Co. follows:

> We offer to purchase 10,000 tons of No. 4 steel pipes at today's quoted price for delivery two months from today. Your acceptance must be received in five days.

Bridge Builders intended to create a (an)
- a. Express contract.
- b. Unilateral contract.
- c. Bilateral contract.
- d. Joint contract.

Answer Sheet

99. a. :::::::::: b. :::::::::: c. d. ::::::::::

Items to be Answered

1. John executed and delivered his check for $2,000 on May 1 payable to the order of Ken who indorsed the check to the order of Lyons for value. Despite John's care in executing the check, Lyons was able to raise the amount to $20,000 and on May 3 transferred it by blank indorsement to Marks who took the check for value and in good faith without notice of the alteration. If the drawee bank refuses to honor the check because of insufficient funds
   - a. Marks would have an action against the bank for failure to pay available funds in John's account.
   - b. Marks would bear the entire loss since the check was nullified by the alteration, though he would have an action against Lyons.
   - c. Marks, as a holder in due course, could recover $20,000 from John.
   - d. Marks, as a holder in due course, could recover $2,000 from John.

2. An instrument is nonnegotiable if it
   - a. Is payable in a foreign currency.
   - b. States it is secured by a mortgage.
   - c. States that it is subject to any other agreement.
   - d. Is issued by a partnership and limited to payment from partnership assets.

3. The transferor of a bearer negotiable instrument who transfers without indorsing but for full consideration
   - a. Is liable to all subsequent holders if there exists a personal defense to the instrument maintainable by the primary party and the transferor was aware of the defense.
   - b. Warrants to his immediate transferee that he has good title.
   - c. Makes **no** warranty that prior signatures are genuine or authorized.
   - d. Engages that he will pay the instrument if his immediate transferor is unable to obtain payment upon due presentment and dishonor because of insufficient funds and due notice is given the transferor.

4. When the holder of a negotiable instrument transfers it for consideration by indorsing "without recourse," he
   - a. Makes **no** warranty as to title as to any subsequent holder.
   - b. Prevents further negotiability.
   - c. Makes the same warranties as an unqualified indorser except that he warrants that he does **not** have knowledge of a defense of any party good as against him rather than that there is **no** such defense.
   - d. Becomes immune from recourse to him by a subsequent holder.

5. Amos purchased a building from Thoms. He paid a small amount of cash and took the building subject to a mortgage given by Thoms to National Bank. Under these circumstances
   - a. Sale of the building to Amos would normally give National Bank an immediate right of action against Thoms.
   - b. Amos became primarily liable on the debt to National Bank.
   - c. Amos incurred **no** personal liability on the debt.
   - d. Payment of the mortgage debt by Amos would give Amos a right of subrogation against Thoms.

6. Pix Company manufactures regular camera film and markets it under its trademarked brand "Fino" and also manufactures a newly developed color film "Unique" with special qualities and a unique development process not presently marketed by others and for which there is no competition. Pix has instituted a resale price maintenance program to protect its products. Based on these facts
   - a. Pix will violate federal antitrust laws by requiring price maintenance on "Unique."
   - b. Pix may legally require purchasers of "Unique" to purchase equal quantities of "Fino" as a condition of sale.
   - c. All states will permit retail price maintenance with respect to "Fino."
   - d. An attempt to maintain retail price maintenance with respect to "Fino" is a *per se* violation of the federal antitrust law.

Items 7, 8, and 9 are based on the following information:

Teff entered Archer's office and stole from Archer some radios and Archer's wallet containing identification. Subsequently, representing himself as Archer, Teff induced Bane to purchase one of the stolen radios for a fair price. Bane gave Teff his check made out to Archer. Teff indorsed the check "Pay to the order of Crown, Archer" and transferred it to Crown for cash in the amount of the check. Crown indorsed the check "Pay to the order of Fox, Crown" and transferred the check to Fox to be applied to his account.

7. Bane's check was
   a. Void *ab initio*.
   b. Bearer paper when Crown took it.
   c. Order paper initially and negotiated by Teff to Crown.
   d. Nonnegotiable absent a valid indorsement by the real Archer.

8. If Fox presents the check to the drawee bank which had **no** notice of any irregularity, the drawee bank
   a. May refuse to cash the check only if it has received a stop-payment order.
   b. Will discharge prior parties if it certifies the instrument.
   c. Will discharge prior indorsers if it pays the instrument.
   d. Will acquire **no** rights against Bane if it pays the instrument.

9. If the drawee bank refuses to honor the check on timely presentment by Fox, he
   a. Has a cause of action against the bank.
   b. Can only succeed in an action against Teff because of his fraudulent acts.
   c. Must proceed against Bane before resorting to any right against any of the indorsers.
   d. Can, after timely notice of dishonor, require Crown to pay the amount of the check.

10. Bob purchased a car from Jones. At Bob's request, Paul guaranteed payment at the time of sale. Which of the following defenses can Paul successfully assert against Jones when sued following nonpayment of the debt by Bob at maturity?
   a. Death of Bob.
   b. Infancy of Bob.
   c. Nondisclosure of facts known to Jones at the time of sale which were unknown to Paul and materially increased the risk.
   d. Lack of consideration by Jones to Paul for guaranteeing payment.

Items 11 and 12 are based on the following information:

Andrews borrowed $20,000 from State Bank giving a mortgage on his building to State in that amount. Subsequently when the balance of the mortgage debt was $19,000, Andrews entered into a contract to sell the building to Baum for $25,000 with Baum to assume the mortgage at the closing date and pay Andrews $6,000. Baum obtained a loan of $6,000 from Thomas secured by a second mortgage, and Inch guaranteed payment of Baum's debt to Thomas.

11. Under the circumstances described above
   a. If State Bank is notified of the transaction and makes **no** protest, Andrews is discharged.
   b. Absent any action by State Bank, Andrews is a surety on the first mortgage debt which Baum assumed.
   c. If Baum defaults on the first mortgage, payment by Andrews would **not** give Andrews a right of reimbursement from Baum.
   d. Inch and Andrews would be cosureties on the two mortgages.

12. With respect to the relationships on the second mortgage
   a. An extension of time by Thomas to Baum, reserving his rights against Inch, would **not** release Inch even though land values were falling.
   b. Thomas must resort to foreclosure upon default by Baum on the second mortgage before seeking payment from Inch.
   c. Inch is an indemnitor rather than a surety.
   d. Duress by Baum on Inch leading to the guaranty will permit Inch to avoid liability to Thomas without regard to Thomas' knowledge of that fact.

13. Park owed Collins $1,000 and $2,000, respectively, on two separate unsecured obligations. Smythe had become a surety on the $2,000 debt at the request of Park when Park became indebted to Collins. Both debts matured on June 1. Park was able to pay only $600 at that time, and he forwarded that amount to Collins without instructions. Under these circumstances
   a. Collins must apply the funds pro rata in proportion to the two debts.
   b. Collins must apply the $600 to the $2,000 debt if there is no surety on the $1,000 debt.
   c. Smythe will be discharged to the extent of $400 if Collins on request of Smythe fails to apply $400 to the $2,000 debt.
   d. Collins is free to apply the $600 to the debts as he sees fit.

Items 14 and 15 are based on the following information:

Marlin ordered merchandise from Plant to be delivered that noon and delivered a check payable to the order of Plant and drawn on Marlin's account in First Bank. The goods were **not** delivered and Marlin exercised his rights to rescind. Plant negotiated the check for full value to Rose who took in good faith and without notice of any defense; Rose then negotiated it for full value to Quirk who knew of Plant's breach of his agreement.

14. If, after rescission, Marlin notified First Bank to stop payment on the check, First Bank
   a. Will incur **no** liability by paying the check if **no** written notification was received prior to payment.
   b. Is liable for any loss suffered by Marlin as a result of First Bank's payment after receiving a written stop-payment order regardless of the time interval between receipt of the order and payment.
   c. Is **not** required to pay even if a valid presentment is made by a holder in due course.
   d. Is liable to Marlin for any loss suffered by Marlin where it had issued its cashier's check in payment of Marlin's check before receipt of the stop-payment order but paid the cashier's check three days after receipt of the stop-payment order.

15. If First Bank pays the check five days after Marlin gave it to Plant,
   a. Without prior knowledge of Marlin's death, the bank would be liable to Marlin's estate if Marlin had had a defense to payment of the check.
   b. Payment by First Bank to Quirk after First Bank received an effective stop-payment order would require First Bank to credit Marlin's account for the amount of the check.
   c. Payment by First Bank to Quirk after Marlin filed voluntary bankruptcy but before notice to the bank would result in denial of an action by the trustee in bankruptcy against the bank for the amount of the check so paid.
   d. Payment by First Bank would require the bank to credit Marlin's account if prior to payment First Bank had learned that Marlin had a valid defense against Plant on the check.

16. Fitz received from Gayle a negotiable instrument payable to the order of Gayle. Fitz received the instrument for value, but Gayle inadvertently did **not** indorse the instrument.
   a. Fitz will be treated as the holder of a bearer negotiable instrument.
   b. If Fitz later obtains Gayle's unqualified indorsement, Fitz's rights as a holder in due course are determined as of the time of indorsement.
   c. Fitz has a right to require Gayle to indorse, but Gayle may satisfy the right by a qualified indorsement.
   d. Fitz has **no** right after accepting the transferred instrument to require Gayle to indorse where he made **no** such request at the time of the transfer.

17. At the request of Pax, Somes and Tabor became cosureties on a loan from Cox to Pax. At the time they agreed to become sureties, Somes placed a limit of $30,000 on his liability and Tabor placed a limit of $20,000 on his; the loan was in the amount of $30,000. Somes and Tabor mutually intended to be cosureties and each promised to pay the loan to the extent of the limit placed should Pax default in payment at maturity. Based on these facts
   a. A release of Tabor by Cox would result in a complete discharge of Somes.
   b. A release of Somes by Cox, reserving Cox's rights against Tabor, would **not** reduce Tabor's obligations.
   c. Insolvency of Somes would discharge Tabor.
   d. Bankruptcy of Tabor before maturity of the note would limit Somes' potential liability to $18,000.

18. An instrument otherwise negotiable is
   a. Negotiable although it provides for stated different rates of interest before and after default.
   b. **Not** a negotiable instrument if it contains a provision for payment at a definite time subject to extension to a further definite time at the option of the holder.
   c. **Not** a negotiable instrument if it states that it is drawn under a letter of credit.
   d. **Not** a negotiable instrument if payable at a definite time but subject to acceleration.

Number 2 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

19. A voluntary petition in bankruptcy may
   a. **Not** be filed by a person who has income in excess of $10,000 per year.
   b. **Not** be filed by a self-employed professional.
   c. Be filed only if insolvency, in the bankruptcy sense, is at least $1,500.
   d. Be filed by an individual who is solvent in the bankruptcy sense.

Items 20 and 21 are based on the following information:

Weld, a wholesaler of canned food, inquired by phone if Mank, a manufacturer, had cases of a specified brand of canned peas on hand. Mank's manager replied that they had 1,000 cases available and that 9,000 additional cases would be manufactured and available the following week. An hour later, Weld wired Mank, "Will take the 1,000 cases for immediate delivery – offer open 5 days." Thirty minutes later in a second wire Weld stated, "Will take 4,000 of the cases to be manufactured." Both wires stipulated the price to be the same as the price previously used in a prior sale by Mank to Weld of the same product. On receipt of the first wire, Mank shipped the 1,000 cases to Weld.

20. In determining when the agreement as to the 1,000 cases resulted in a contract
    a. Receipt of the telegram by Mank constitutes acceptance by Weld of the offer by Mank.
    b. Shipment by Mank constituted acceptance of the offer by Weld to Mank, assuming notification was received by Weld within a reasonable time.
    c. Only actual delivery of the goods to Weld at Weld's place of business would constitute acceptance by Mank of the offer by Weld.
    d. Weld's telegram was an offer which could be accepted by Mank only upon receipt by Weld of actual written acceptance by Mank.

21. As to Weld's second telegram ordering 4,000 cases
    a. Weld's telegram completed the sale of goods.
    b. Weld's telegram completed a contract to sell goods.
    c. A prompt reply of acceptance by Mank would operate to transfer to Weld title to the cases as completed by Mank.
    d. Weld's offer was revocable.

Items 22 and 23 are based on the following information:

Bates ordered 1,000 units of merchandise from Watson, a wholesaler, at a unit price of $50 each, with delivery to be made at Bates' warehouse after April 11 but in **no** event later than April 15 with payment to be made 30 days after delivery. Watson accepted Bates' offer.

22. If Watson notifies Bates on April 10 that he will **not** be able to deliver the merchandise until May 2
    a. Bates may notify Watson that he is treating the contract as terminated immediately, but if he does so he waives any right to damages for breach of contract.
    b. If Bates elects to do nothing, he will be bound if Watson subsequently tenders the goods on April 15.
    c. Watson's notification is without legal effect until actual breach occurs.
    d. Watson's action gives Bates **no** right to recovery if Watson can show that a sudden drop in the market occurred and Watson would have suffered a greater loss if the contract had been performed.

23. If Watson ships the goods to Bates and the shipment arrives on April 12
    a. Bates must inspect all items at the time delivery is tendered or waive any defects.
    b. Bates may inspect the goods prior to accepting delivery but may **not** accept conforming goods while rejecting the nonconforming goods if he wishes to preserve his remedies for any breach of contract as to the latter.
    c. If Watson delivers 1,000 units of a newer model of the merchandise ordered reasonably believing it to be acceptable and Bates rejects the merchandise as nonconforming, Watson may hold Bates to the contract terms by reasonably notifying Bates of his intent to cure and delivering conforming units by April 15.
    d. If the goods are damaged but salable as damaged merchandise, Bates must immediately seek to sell them and then he may recover any loss as damages from Watson.

24. Of the following items, the highest priority for payment in full before general creditors' claims in a bankruptcy proceeding is assigned to
    a. Wages, in a limited amount, if earned within three months preceeding bankruptcy.
    b. Wages owed to an insolvent employee.
    c. Administration costs of bankruptcy.
    d. Unpaid federal income taxes.

25. Argot wrote Palm offering to sell him specified merchandise with the offer to remain open 30 days. Ten days later, Argot and Palm orally agreed on the terms of the sale, and Argot prepared a letter which he sent to Palm stating, "This incorporates our agreement." The letter specified the goods but failed to include the agreed price. Later, prior to the date specified for delivery Argot agreed in writing to modify the terms of the contract as requested by Palm; there was no consideration for the modification. Based on these facts
    a. Argot's offer was revocable until accepted by Palm.
    b. If Palm seeks to enforce the agreement, Argot may assert the Statute of Frauds as a defense since neither letter specified any price for the goods.
    c. Lack of consideration for the modification of the agreement would **not** prevent its enforceability.
    d. Neither Argot nor Palm could enforce the agreement since Palm had **not** signed any writing.

Items 26 and 27 are based on the following information:

Pam wrote Matz setting forth specifications for a printing press of a unique nature to be constructed to order and asked for a firm price offer if Matz were interested. Matz telegraphed Pam one week later, "Offer to construct as per your letter for twenty thousand seven hundred dollars cash on November delivery. Offer terminates two days. Matz." The telegram omitted the words "seven hundred" when delivered to Pam. Pam immediately phoned Matz and stated, "I accept as stated in your telegram." Matz said, "Done."

26. Based on the above facts and assuming **no** further writing
    a. **No** contract resulted since Matz did **not** intend to sell the press for $20,000.
    b. Neither party is bound because of mutual mistake.
    c. If Matz completed the contract and delivered the press to Pam, Matz would be deemed to have made an implied warranty against infringement of any patent held by others.
    d. Pam probably **cannot** assert the Statute of Frauds as a defense to a suit by Matz if he notifies Matz that he will **not** take the goods after Matz has completed about 40% of the work.

27. If subsequent writings had been exchanged and Pam and Matz had a definite agreement
    a. Matz warrants by delivery that the goods will perform the printing job Pam had in mind in specifying the unique construction.
    b. If Matz completes the press but wrongfully refuses to deliver, Pam may require him to specifically perform.
    c. Pam would **not** have an insurable interest in the press until risk of loss or title passes from Matz.
    d. If Matz notifies Pam that Matz will **not** complete the contract, Pam gives up the right to damages if Pam cancels instead of pursuing other remedies.

28. A bankrupt can be denied a discharge in bankruptcy if
    a. He had failed to keep or preserve books of account or records.
    b. He was discharged in bankruptcy eight years earlier.
    c. He permitted a creditor to obtain a lien on his property three months prior to bankruptcy and did **not** act to discharge it.
    d. General creditors with provable claims will be unable to receive more than 10% of the amount of their claims.

29. When a contract for the sale of merchandise has been breached by the seller's failure to deliver goods conforming to the contract, the buyer's remedy of "cover"
    a. Is exclusive if substitute goods are readily available.
    b. Is normally limited to nondelivery of fungible goods.
    c. Limits primary damages (as distinguished from incidental and consequential damages) to the difference between the contract price and the market price of comparable goods at the time the buyer learns of the breach.
    d. Requires a reduction in damages claimed for expenses saved in consequence of the seller's breach.

30. A provision in a contract for the sale of goods providing that the seller may accelerate payment at will when he deems himself insecure
    a. Is void as against public policy and ignored in determining contract rights.
    b. Makes the agreement illusory and prevents a contract.
    c. Gives the seller a preferred creditor's status.
    d. Is enforceable subject to the good faith belief of the seller.

31. Under Chapter XI of the Bankruptcy Act, a plan to be accepted and confirmed by the Court
    a. Must be accepted by all creditors.
    b. May be approved by a majority of creditors by number.
    c. May be approved by one-third of the creditors by number if their claims equal two-thirds of provable claims.
    d. Requires approval of a majority both as to number of creditors and amount of claims of creditors where claims have been proved and allowed.

32. Bennet was a salaried employee of Selma Company earning $250 per week. He had accumulated unsecured debts of $15,000 to 15 creditors and had assets of $1,000. Bennet's wife was well to do and had **no** debts. If Bennet committed an act of bankruptcy
    a. Bennet may **not** be forced into involuntary bankruptcy if his wife has sufficient assets to pay his debts.
    b. Bennet as a salaried employee may **not** be forced into involuntary bankruptcy.
    c. A creditor of Bennet with an unsecured claim of $8,000 may force Bennet into involuntary bankruptcy by filing a petition showing his provable claim.
    d. Three of Bennet's creditors having aggregate provable and unsecured claims of $900 may force Bennet into involuntary bankruptcy.

Items 33 through 36 are based on the following information:

Ambrose undertook to stage a production of a well-known play. He wired Belle, a famous actress, offering her the lead at $1,000 per week (for six evening performances per week) for six weeks from the specified opening night, plus $1,000 for a week of rehearsal prior to opening. The telegram also said, "Offer ends in three days."

33. Assuming Belle's reply was received by Ambrose within the time limit, it would
   a. Be an effective acceptance if she telephoned Ambrose and accepted within the three-day period and prior to receiving any indication of revocation of the offer even though Ambrose had previously dispatched a letter to Belle revoking the offer.
   b. Be an effective acceptance only if she replied by telegram.
   c. Be an effective acceptance if she replied immediately, "Fine if Howard is my leading man."
   d. **Not** be an effective acceptance if she replied, "Fine, but I hope you will try to line up Howard as my leading man."

34. Ambrose's death
   a. Would **not** terminate the offer if it occurred after Belle sent a telegraphed acceptance but before receipt of the telegram at Ambrose's office.
   b. Would terminate any contract previously made with Belle.
   c. On the day of the offer would **not** prevent Belle from subsequently accepting within the three-day period.
   d. Transforms the offer into an offer to enter into a unilateral contract.

35. Assuming a contract between Ambrose and Belle and that Belle did **not** perform after the third week of the six-week run
   a. If Belle were able to perform, a court would probably order specific performance.
   b. If Belle became unable to perform because of illness, Belle could hold Ambrose to his contract if she arranged for the appearance of a substitute star of at least equal fame and ability.
   c. If Belle became ill and it appeared that she would miss a substantial number of performances, Ambrose might terminate the contract but would be liable for payment for performances previously given.
   d. Belle's refusal to perform would **not** have constituted a breach of contract if Ambrose had been declared a bankrupt.

36. Ambrose agreed to pay a specified rental to Lord under a lease agreement calling for rental of one of two identical side-by-side theaters owned by Lord (Theater "A" and Theater "B"). It was later agreed that Theater "A" would be used for the run of the play but not to exceed nine months in return for a fixed weekly fee plus a percentage of gross receipts. Under these circumstances
   a. The lease if oral would be void.
   b. The lease, even if written, would be illusory since **no** set lease term is provided.
   c. If the interior of Theater "A" was burned out by fire, Lord would probably be excused from performance even though Theater "B" was available and Ambrose was willing to accept the substitution.
   d. The lease if oral would be valid and **not** voidable.

Number 3 (Estimated time -- 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

37. The board of directors of Anchor Corporation and of Bridge, Inc., two corporations whose shares are listed on a major stock exchange, have discussed the possibility of merging the companies. Considering such a merger,
   a. Unanimous approval by both boards of directors of the merger would permit the merger without approval of shareholders of the corporations.
   b. Approval by at least a two-thirds majority of the board of directors of each corporation would permit merger without shareholder approval.
   c. If the merger were validly accomplished by an exchange of Anchor stock for Bridge stock with Bridge surviving, creditors of Anchor could look to Bridge for payment of their claims.
   d. The new board of directors immediately after the merger of Anchor into Bridge automatically consists of the previous boards of the two corporations.

38. Kay owned a building valued at $100,000 when a fire occurred causing $60,000 damage. The loss was insured under an Ace Insurance Company fire insurance policy in the amount of $60,000 which contained an 80% coinsurance clause. Kay's recovery under the policy will be limited to
   a. $60,000.
   b. $48,000.
   c. $45,000.
   d. $36,000.

Items 39, 40, and 41 are based on the following information:

Korn was one of several promoters interested in organizing Alpha Corporation. Korn entered into an employment contract for the services of Wentz. It was mutually understood that Wentz would perform certain duties and that these might be performed in behalf of a corporation yet to be formed. Korn also entered into an agreement with Bates Company for services to be rendered by the corporation at a future date.

The corporation was formed and began operations, but a defective filing prevented compliance with the requirements for legal incorporation.

39. Failure to comply strictly with all of the filing requirements probably resulted in
   a. A *dejure* corporation.
   b. A *defacto* corporation for some purposes, at least.
   c. The formation of a partnership.
   d. The unenforceability of all agreements mentioned.

40. Assume that Alpha Corporation was properly formed, and Wentz performed services for the corporation in accordance with his agreement with Korn. If Wentz seeks to recover the compensation agreed upon in his agreement with Korn
   a. The corporation is probably liable to Wentz for the salary under the agreement if it adopted the agreement.
   b. The corporation is probably automatically bound by the preincorporation agreement of Korn as its agent.
   c. Absent express adoption of the agreement by Alpha's board of directors, Wentz may recover for his services to the corporation only from Korn.
   d. Any obligation Korn undertook under the agreement is terminated if Wentz assumes a position with the corporation at the salary specified in the agreement.

41. After proper incorporation of Alpha, it was decided to purchase a plant site. Gold, a newly elected director, has owned a desirable site for many years. He purchased the property for $60,000, and its present fair value is $100,000. What would be the result if Gold offered the property to Alpha for $100,000 in an arm's-length transaction with full disclosure at a meeting of the seven directors of the corporation?
   a. The sale would be proper only upon requisite approval by the appropriate number of directors and at **no** more than Gold's cost, thus precluding his profiting from the sale to the corporation.
   b. The sale would be void under the self-dealing rule.
   c. The sale would be proper and Gold would **not** have to account to the corporation for his profit if the sale was approved by a disinterested majority of the directors.
   d. The sale would **not** be proper, if sold for the present fair value of the property, without the approval of all of the directors in these circumstances.

42. The federal Fair Labor Standards Act
   a. Prohibits any employment of a person under 16 years of age.
   b. Requires payment of time-and-one-half for overtime to actors engaged in making television productions.
   c. Contains an exemption from the minimum-wage provisions for manufacturing plants located in areas of high unemployment.
   d. Prohibits the delivery by a wholesaler to a dealer in another state of any goods where the wholesaler knew that oppressive child labor was used in the manufacture of the goods.

43. If an employer carried workmen's compensation coverage on his employees, an injured employee would
   a. Probably be covered even if the injury was caused by a co-worker.
   b. **Not** be covered if the injury was caused by grossly negligent maintenance by the employer.
   c. Probably **not** be covered if the injury was due to a violation of plant rules in operating the machine.
   d. Be covered if the employee was driving to work from his home.

44. Abner purchased a life insurance policy on his life and named Barbara as beneficiary. Later he borrowed from Charles and assigned the policy to Charles as security for the debt. Abner died while the debt was unpaid. Under these circumstances
   a. Barbara will be entitled to the entire proceeds if she had an insurable interest and did **not** consent to the assignment even if Abner had retained the right to change the beneficiary.
   b. If, prior to the loan, Barbara had been named irrevocably as beneficiary without consideration, she will be entitled to the entire proceeds absent her consent to any change in her rights.
   c. The assignment operates to change the beneficiary of the policy from Barbara to Charles, but he is liable to Abner's estate for proceeds in excess of amounts due him.
   d. Normally assignment is **not** permitted to become effective if the value of the policy at the time exceeds the debt.

45. Where an insured owns a life insurance policy on his life and has borrowed against it without repaying the loan at the time of his death
   a. **No** proceeds are payable if the loan was equal to full cash surrender value prior to the death of the insured.
   b. The face amount must be paid to a beneficiary irrevocably named prior to the loan where **no** notice of the loan was given to the beneficiary.
   c. The policy becomes incontestible to the extent of the amount of the loan.
   d. The insurer may withhold the amount of the loan and interest from proceeds otherwise payable on the insured's death even though after the loan the policy was assigned for consideration to a third party who had **no** notice of the loan.

46. An employee was injured while working on a machine in his employer's plant. The employer carried workmen's compensation with Ace Casualty as the carrier. In this circumstance
   a. If the injury was the fault of a third person covered by insurance, contribution is the usual method of apportioning the effect of the injury.
   b. The existence of workmen's compensation covering the injury precludes an action against the machine manufacturer if faulty design caused the injury.
   c. If the injury was covered, the employee normally has **no** cause of action for damages against the employer.
   d. Payment by the carrier usually subrogates the carrier to the injured worker's rights against a negligent employer.

Items 47, 48, and 49 are based on the following information:

Coe Corporation is authorized to issue 15,000 shares of \$100 par value common stock of which 10,000 shares are issued and, of these, 500 shares are held as treasury stock. The treasury stock was appropriately acquired under applicable state law.

47. A shareholder owning 5% of the outstanding stock of Coe has asked the corporation to repurchase his shares of stock. Should Coe want to repurchase the stock, which of the following statements best describes the effect to the corporation?
   a. The repurchase of the shares by the corporation would normally require stockholder approval.
   b. Absent stockholder approval, shares may be repurchased by the corporation only by affording all stockholders a right of pro rata redemption.
   c. Repurchased shares must normally be retired if they were never authorized.
   d. Repurchase of the shares may **not** be made if such repurchase would render the corporation insolvent.

48. At a meeting of seven members of Coe's board of directors which constituted a quorum, the directors voted four to three to acquire the assets of Zeta Company in exchange for 300 shares of Coe's common stock. In this circumstance
   a. The board could **not** properly act on such a matter without attendance by all board members.
   b. If the board's action provided for the exchange of 300 shares of the authorized but previously unissued shares for Zeta's assets, the board's action would be proper regardless of the preemptive rights of shareholders.
   c. The board's action was **not** proper because the action required the affirmative vote of at least five directors.
   d. Shareholder approval would be required for the action of the board to be effective, whether treasury stock or previously authorized but unissued stock is to be exchanged for Zeta's assets.

49. The treasury stock held by Coe
   a. Is treated as issued and outstanding stock.
   b. May be resold without regard to preemptive rights.
   c. May be voted by management.
   d. Normally entitles a purchaser at a later date to an amount equal to all dividends per share paid while the shares were held by the corporation as treasury stock.

50. Under a buy-and-sell agreement to be funded by life insurance, each of the three partners of a public accounting firm took out a \$50,000 policy on the life of each of his other two partners. The agreement provided that on the death of the first, each of the other two partners was to collect the proceeds of the policy he owned on the life of the decedent and purchase one-half of the decedent's partnership interest from the decedent's estate for that amount. Each partner paid the premiums on the lives of his fellow partners from his individual funds. In this situation
   a. Prior to the death of any partner, the policies are partnership assets.
   b. On the death of a partner, a surviving partner has the absolute right to purchase from the decedent's estate the policy of insurance (on the survivor's life) which had been owned by the decedent.
   c. Continued ownership and payment of premiums by the estate of a deceased partner on a policy the decedent had owned on his former partner would probably give rise to a defense of lack of insurable interest if the insured partner later died.
   d. On the death of a partner, the estate of the decedent could validly transfer the policy it held on the life on one surviving partner to the other surviving partner.

51. The "incontestable clause" in a life insurance policy usually provides that

   a. The insured is covered on delivery of the policy regardless of any misstatement in the application.
   b. If death occurs after a specified period of time, a misstatement in the application will **not** constitute a defense by the insurer.
   c. Suicide of the named insured will **not** constitute a defense by the insurer.
   d. Only the estate of the insured may contest the named beneficiary's rights to proceeds of the policy.

52. "Split-dollar" life insurance usually refers to a life insurance contract

   a. Whose initial face amount is adjusted for price index changes.
   b. Which provides for splitting proceeds in proportion to the ratable contributions of premiums of two or more persons.
   c. Where an employer of the insured pays the portion of the premium equal to the increase in cash surrender value of the policy and the employer's interest in the proceeds is limited to this amount.
   d. Where an employer of the insured employee is obligated to match premiums equally with those paid by the insured employee.

53. Alphonse, a sole CPA practitioner, obtained a malpractice insurance policy from the Friendly Casualty Company. In regard to this coverage

   a. Issuance of an unqualified opinion by Alphonse when he knows the statements are false does **not** give Friendly a defense.
   b. The policy would automatically cover the work of a new partnership formed by Alphonse and Borne.
   c. Friendly will **not** be subrogated to rights against Alphonse for his negligent conduct of an audit.
   d. Coverage includes injury to a client resulting from a slip on a rug negligently left loose in Alphonse's office.

54. Bryce owned a building valued at $100,000 before a fire. It was covered by a fire insurance policy issued by Bolt Insurance in the amount of $60,000. The policy contained a 90% coinsurance clause. The building was totally destroyed by fire. Bryce's recovery will be limited to

   a. $60,000.
   b. $54,000.
   c. $48,000.
   d. $0.

Number 4 (Estimated time — 25 to 30 minutes)

Part a. In the course of your examination of the financial statements of your client, Lazy L Motels Corporation, you discovered certain problems relating to the corporation's most recently acquired motel units. On November 15, 1973, Lazy L acquired title to a newly constructed thirty-six-unit motel complex. In connection with the purchase, Lazy L obtained a real-property title search and title insurance from the Safety Title Insurance Company, Inc. The deed was promptly recorded.

Subsequently, the following facts were discovered:

1. There was an unrecorded first mortgage of $200,000 on the real property. Lazy L was unaware of this mortgage when the motel complex was purchased.
2. The survey revealed a two-foot encroachment on the rear adjoining land by five of the motel units. The title company took an exception to insuring this two-foot portion. Lazy L did not realize the implications of the exception taken by the title company.
3. The furniture, appliances, trade fixtures, and all other personal property were subject to a $25,000 security interest per an agreement with the Ace Loan Corporation. The agreement had been properly recorded by Ace. Lazy L was unaware of this security interest when the motel complex was purchased.

Required:

In separately numbered paragraphs, discuss the legal implications to Lazy L of each of the above discoveries.

Part b. Reynolds leased a manufacturing building from Philip under a written lease for a period of five years at a specified rental and with a provision that the lessor would keep the structure in repair.

Reynolds subleased a portion of the lower floor to Signor giving him access through a hallway from the main entrance. Philip subsequently mortgaged the building, and Central Savings, the mortgagee, ultimately foreclosed and acquired good title to the property. Reynolds was unable to get Central Savings to make certain minor repairs and had withheld rent in an amount equal to the repairs he was forced to make. Central Savings meanwhile notified both Reynolds and Signor that the lease was terminated and that both were to pay rent directly to it for one month and then vacate.

Required:

1. Discuss Reynolds' right to withhold rent in the amount of repairs.
2. Absent a breach by the tenants, discuss Central Savings' right to:
   a. Evict the tenants.
   b. Require Signor to pay the rent directly to it.

Number 5 (Estimated time — 25 to 30 minutes)

Part a. Jones, CPA, was engaged by Dee Co. to examine and report on its financial statements which were required by the National Bank to accompany Dee's application for a $50,000 loan. Jones was informed that the primary purpose of the financial statements was to obtain the bank loan. National Bank previously had loaned Dee Co. $100,000 for five years at 6% with the typical call provisions requiring immediate repayment upon default or for failing to maintain certain current ratio tests. This loan was still owing when Jones was engaged.

Jones discovered that Dee's accounting records were seriously deficient. He informed Dee's president of the deficiencies and that he would have to disclaim an opinion on any financial statements which might be prepared from the records. The president then prevailed upon Jones to assist the company accountant to "get the books in shape and, if possible, to prepare unaudited financial statements for internal use only."

With the assistance of Dee's accountant, Jones was able to prepare a set of unaudited statements. During this time Jones learned that a physical-inventory count had not been taken, and that the inventory per books was an estimate made by management. This disclosure was not made in the financial statements. The inventory reported in the balance sheet was material in relation to the financial statements taken as a whole.

Jones had the statements typed on his stationery without marking each statement "unaudited–for internal use only." He delivered a copy of the statements to each member of the board of directors (all were members of management) accompanied by his report as follows:

> *The accompanying balance sheet of Dee Co., as of (date), and the related statements of income and retained earnings and changes in financial position for the year then ended were not audited by me and are restricted to internal use only and accordingly I express no opinion on them.*
>
> *Jones, CPA*

Dee's president removed Jones' report and used the financial statements to obtain the additional loan from National Bank. Jones had no knowledge of these acts.

It was subsequently learned that Dee's book inventory was significantly overstated. Dee became insolvent and suit was brought against Jones by National.

Required:

Discuss the possibilities including countering arguments of Jones being liable to National.

Part b. Your client, Lux Corporation, is a small food manufacturing company with a single plant located in its state of incorporation and has outstanding 200,000 shares of $10 par value common stock which is selling at about that price in infrequent sales. Lux desires to raise $500,000 of additional working capital and is considering the following alternatives:

1. Sale of $500,000 of a new issue of convertible debentures to Kelly, a sophisticated investor who formerly had been an executive of the Company. Kelly retired and now lives in a neighboring state.
2. Sale of $500,000 of additional common stock to local businessmen and other local investors.
3. Borrowing of $500,000 from a local bank on a nonnegotiable demand note.

Required:

In separately numbered paragraphs discuss the impact of the registration requirements of the Securities Act of 1933 as it applies to each of the above alternatives.

Part c. Mekto Corporation's sole issue of stock is traded on a national exchange. In conducting the year-end examination of its financial statements, the auditor learned that Mekto's research department had perfected a manufacturing process which would have a very positive and material effect on future earnings. Mekto reported the new process as an asset at its nominal development cost and made no announcement of the development.

When a rumor about the new process started in late January, Mekto's president promptly telephoned financial papers in several states and announced that there was no substance to the rumor. A number of papers reported the president's denial of the rumor. Thereafter Mekto's stock traded in its normal narrow range. In February, relying on the information reported in the financial press, Howard sold a large block of his Mekto stock at the current market price.

Mekto's president made a public announcement about the perfection of the new process the following June. The announcement precipitated a dramatic increase in both the price and volume of trading of Mekto's stock. Neither Mekto nor any person with knowledge of the process engaged in trading Mekto's stock prior to the public announcement of the discovery.

Required:

Discuss Howard's rights against Mekto and its president under federal securities law.

Number 6 (Estimated time —— 25 to 30 minutes)

Part a. In examining the financial statements of Plover Corporation, you learn that Plover hired Amber to manage its farm and gave him authority to purchase seed up to a maximum of $500 per year. Amber was also given authority to hire employees to help operate the farm. Plover also gave Amber authority to buy for Plover a forty-acre tract, adjacent to the farm, if it became available, and to collect the monthly rental of a house located on the farm.

Amber purchased seed from Supplee as authorized but exceeded his authority by contracting in Plover's name with Supplee for fertilizer in the amount of $600. Amber hired Mans to operate a farm tractor. While operating the tractor in a negligent manner, Mans destroyed a boundary fence belonging to Naybor. Meanwhile, Amber had entered into a contract to purchase the forty acres from Honer, its owner, without revealing that he was purchasing for Plover.

Plover, on learning of the Mans incident, discharged Amber. Amber, who had been collecting the rents on the house, promptly collected the rent then due for the current month from the lessee and disappeared. The lessee did not know of Amber's discharge.

Required:

1. Discuss Plover's liability to Supplee on the order for fertilizer.
2. To what extent, if any, is Plover liable to Naybor for Mans' actions?
3. What are Plover's rights under the agreement for the forty acres?
4. Discuss Plover's liability on the contract for the purchase of the land if it wishes to avoid the obligation.
5. Discuss Plover's rights to recover from the tenant of the house for the last rental payment made to Amber.

Part b. Partridge entered into a written contract with Alder whereby Alder was to have an exclusive right for nine months to sell Partridge's farm. Alder was required to publish specified advertisements at his expense and was to be entitled to a commission of $10,000 upon sale. Alder advertised as required. One month later Partridge notified Alder that the right to sell was revoked. One day after receiving Partridge's revocation, Alder entered into a contract of sale of the farm to Tenney who had relied on the advertisement authorizing Alder to sell for Partridge.

Required:

1. What rights, if any, does Tenney have under the agreement with Alder?
2. What are the rights of
   a. Partridge against Alder?
   b. Alder against Partridge?

Part c. Arms, Balk, and Clee formed a partnership to operate a retail drug and sundries store under the name Drug Shop. Arms and Balk each contributed $25,000, and Clee contributed the store building in which the business was to be carried on. Clee was credited with a contribution of $50,000, the fair value of the property. Clee retained title in his own name. It was agreed that Arms would have the sole right to purchase merchandise on credit. The partners agreed that Balk was to act as manager of the store. The firm hired Dell, a pharmacist, for a five-year term and agreed to pay him a fixed annual salary plus 10% of the profits.

Following are events which occurred subsequent to the formation of the partnership.

- Fricke, a supplier of fixtures, indicated to the partners that he would sell fixtures to the firm on credit only if Dell, the pharmacist and a wealthy man, was a partner. Dell, who was present, said that he was a partner, and the sale on credit was made. Dell, however, later notified all others dealing with the firm that he was not a partner.

- Balk ordered merchandise, for resale by the store, on credit from a wholesaler in the firm name.

- Else was admitted as a partner with a 1/5 interest in the partnership and in profits and losses upon payment of $40,000.

- Clee, who was generally known to be a partner in the firm, (a) guaranteed in writing and in the firm name a note executed by a customer in purchasing a car for the customer's own use, and (b) conveyed in his own name the store building to Sweeney.

Required:

1. Prior to admitting Else as a partner, if the partnership agreement was silent about sharing profits and losses, how should the partners share a remaining profit of $30,000 after all payments to Dell? Explain.
2. If the partnership becomes insolvent, may creditors hold Dell liable as a partner? Explain.
3. Can the wholesaler hold the firm to the contract? Explain.
4. Will Else have any liability to creditors of the firm for obligations which arose prior to his admission? Explain.
5. Discuss the liability of the firm on the customer's note in the event of default.
6. Discuss whether Sweeney would obtain good title to the building.

Number 7 (Estimated time — 25 to 30 minutes)

Part a. Monolith Industries, Inc., manufactures appliances and has been the major supplier of appliances to Wilber Force Corporation, a chain of retail appliance stores. The financing arrangement between Monolith and Wilber Force calls for the sale by Monolith to Wilber Force of appliances to be resold to the public through Wilber Force's chain of appliance stores. Title to the merchandise has been retained by Monolith until receipt of payment. Monthly accountings and payments have been rendered by Wilber Force to Monolith.

Monolith filed a financing statement with the appropriate jurisdictions involved pursuant to the Uniform Commercial Code. The financing statement clearly revealed the debtor-creditor relationship between the parties, described the goods in general terms, and set forth Monolith's security interest in the various appliances sold to Wilber Force. It also contained a provision asserting Monolith's rights against any and all proceeds arising from the sale of said appliances by Wilber Force.

Wilber Force is in financial difficulty. Monolith is asserting rights to certain chattel paper (i.e., installment-sales contracts and non negotiable notes) received by Wilber Force arising from the sale of Monolith appliances to its retail customers. Double Discount Corporation purchased the chattel paper in question from Wilber Force in the ordinary course of its business and took possession of all the paper at the time it was purchased. Double Discount was aware of Monolith's security interest in the inventory. Both Monolith and Double Discount claim ownership of the paper.

Required:

1. Does Monolith have a perfected security interest? Explain.
2. Assuming Monolith has a perfected security interest, does it include proceeds? Explain.
3. Does Monolith have any rights against Double Discount regarding the chattel paper? Explain.

Part b. While examining accounts receivable during the current audit of Dodson Corporation you encountered the following situation involving Excelsior Sales Distributors, Inc., one of Dodson's customers.

In the past, Dodson had sold Excelsior various hi-fi components for sale to its retail customers in the ordinary course of business. The credit arrangement between the parties provided for payment by Excelsior on a 2/10, net/30 basis. Excelsior fell behind on payments for merchandise it had purchased, and Dodson demanded a security interest in the merchandise for which payment had not been received. Negotiagions between the parties resulted in the following plan which has been executed.

- Excelsior returned to Dodson all of the unsold merchandise in its possession which had been delivered by Dodson. (This was insufficient to cover the outstanding obligation to Dodson because merchandise which previously had been delivered had been sold by Excelsior and was not available for repossession.) Dodson placed the merchandise in a bonded warehouse retaining a negotiable warehouse receipt for the items repossessed from Excelsior. The merchandise was segregated in the warehouse for identification.

- Excelsior agreed to pay all storage and delivery costs on the repossessed merchandise.

- Dodson agreed to release the repossessed merchandise to Excelsior upon payment in cash for each delivery.

- Dodson agreed not to file a financing statement on the repossessed merchandise.

- All future sales were to be made on a cash basis, but only after Excelsior satisfied all outstanding debts to Dodson.

Subsequently, under a separate agreement, Excelsior's owners, who were also its directors and officers, guaranteed all outstanding obligations of Excelsior to Dodson including any deficiency which may arise on disposition of the repossessed merchandise.

Six months later, Excelsior filed a voluntary petition in bankruptcy. Dodson is asserting rights to the merchandise it sold and repossessed. Dodson also seeks to collect from Excelsior's owners on their guarantee for the deficiency resulting from merchandise previously delivered less the proceeds from the sale of merchandise repossessed.

Required:

1. Does Dodson have a perfected security interest in the repossessed merchandise? Explain.
2. Assuming Dodson is a secured creditor of Excelsior, can the duly appointed trustee in bankruptcy set aside Dodson's security interest in the repossessed merchandise? Explain.
3. Can Dodson recover against Excelsior's owners upon their guarantee for any remaining deficiency after a valid auction sale of the repossessed merchandise? Explain.

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING THEORY

(Theory of Accounts)

May 10, 1974; 1:30 to 5:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

	Estimated Minutes	
All questions are required:	*Minimum*	*Maximum*
No. 1	25	30
No. 2	25	30
No. 3	25	30
No. 4	25	30
No. 5	25	30
No. 6	25	30
No. 7	25	30
Total for examination	175	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time -- 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of issues in financial and managerial accounting.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. Which of the following accounts should be classified as a current asset in a balance sheet?
   a. Machinery.
   b. Cash.
   c. Goodwill.
   d. Taxes payable.

Answer Sheet

99. a. :::::::::: b. ▬▬ c. :::::::::: d. :::::::::

Items to be Answered

1. Which of the following items should **not** be classified as a contingent liability?
   a. Accommodation indorsement of liability.
   b. Premium offers to customers for labels or box tops.
   c. Pending lawsuits.
   d. Taxes that are in dispute.

2. Preferred terminology **limits** the use of the term "reserve" to
   a. Actual liabilities of known amounts.
   b. Appropriations of retained earnings.
   c. Estimated liabilities.
   d. Valuation (contra) accounts.

3. The depreciation method that does **not** result in decreasing charges is
   a. Double-declining-balance.
   b. Fixed-percentage-on-book-value.
   c. Sinking-fund.
   d. Sum-of-the-years'-digits.

4. Upon purchase of certain depreciable assets utilized in its production process, a company expects to be able to replace these assets by adopting a policy of never declaring dividends in amounts larger than net income (after deducting depreciation). If a net income is earned each year, recording depreciation will coincidentally result in sufficient assets being retained within the enterprise which, if in liquid form, could be used to replace those fully depreciated assets if
   a. Prices remain reasonably constant during the life of the property.
   b. Prices rise throughout the life of the property.
   c. The retirement depreciation method is used.
   d. Obsolescence was an unexpected factor in bringing about retirement of the assets replaced.

5. For a two-year period following a properly implemented quasi-reorganization Bruno Corporation operated profitably and paid dividends equal to 20% of its net income each of the two years. How could one determine that the quasi-reorgainzation had occurred?
   a. Could **not** unless comparative balance sheets were presented.
   b. By the nature of the reserves in the stockholders' equity section.
   c. By the dating of retained earnings.
   d. By the conservative dividend policy.

6. Which of the following is true in applying the lower-of-cost-or-market rule to work-in-process inventory?
   a. This category of inventory is an exception and the rule does **not** apply.
   b. Costs of completing the inventory are added to costs of disposal and both deducted from estimated selling price when computing realizable value.
   c. Market value **cannot** ordinarily be determined.
   d. Equivalent production is multiplied by the selling price.

7. Davis Corporation owns some shares of stock which its management would like very much to sell. There is, however, serious question about the company's ability to sell the stock quickly at other than a sacrifice price. If the investment is valued at cost, it should be classified on the balance sheet as a
   a. Current asset.
   b. Long-term investment.
   c. Contra item under capital.
   d. Deferred charge.

8. A labor efficiency debit balance indicates that
   a. The wage rate paid to production workers was below the standard.
   b. The wage rate paid to production workers was above the standard.
   c. Less time was spent on production than was called for by the standard.
   d. More time was spent on production than was called for by the standard.

9. The ratio of earnings before interest and taxes to total interest expense is a measure of
   a. Liquidity.
   b. Risk.
   c. Activity.
   d. Profitability.

10. On a balance sheet what is the preferable presentation of notes or accounts receivable from officers, employees, or affiliated companies?
   a. As trade notes and accounts receivable if they otherwise qualify as current assets.
   b. As assets but separately from other receivables.
   c. As offsets to capital.
   d. By means of notes or footnotes.

11. What is the theoretically preferred method of presenting minority interest on a consolidated balance sheet?
   a. As a separate item within the deferred-credits section.
   b. As a deduction from (contra to) goodwill from consolidation, if any.
   c. By means of notes or footnotes to the balance sheet.
   d. As a separate item within the stockholders' equity section.

12. Where a "general-purpose contingency reserve" has been set up in a prior fiscal year, how is the abolition of the "reserve" during the current fiscal year handled?
   a. As a prior-period adjustment.
   b. By charging the "reserve" with the type of anticipated loss which occurred during the current fiscal year.
   c. As an extraordinary item.
   d. By charging the "reserve" and crediting retained earnings.

13. Which of the following tables would show the largest value for an interest rate of 5% for six periods?
   a. Amount of 1 at Compound Interest.
   b. Present Value of 1 at Compound Interest.
   c. Amount of Annuity of 1 per Period.
   d. Present Value of Annuity of 1 per Period.

14. For accounting purposes the "operating cycle concept"
   a. Causes the distinction between current and noncurrent items to depend on whether they will affect cash within one year.
   b. Permits some assets to be classified as current even though they are more than one year removed from becoming cash.
   c. Has become obsolete.
   d. Affects the income statement but **not** the balance sheet.

15. What is the term that means that all manufacturing costs (direct and indirect, variable and fixed) which contribute to the production of the product and are traced to output and inventories?
   a. Job-order costing.
   b. Process costing.
   c. Full or absorption costing.
   d. Variable or direct costing.

16. What are prime costs?
   a. The first costs incurred on a job.
   b. Indispensible as distinguished from avoidable costs.
   c. Direct materials and direct labor.
   d. Costs incurred on joint products before the split-off point.

17. In processing goods through a factory, materials are successively run through production departments A, B, and C. For product-costing purposes, when dealing with items received from A, department B should treat them as
   a. Raw materials.
   b. Work in process.
   c. Finished goods.
   d. Equivalent units.

18. Which of the following is **not** an acceptable treatment of factory overhead variances at an interim reporting date?
   a. Apportion the total only between work-in-process and finished-goods inventories on hand at the end of the interim reporting period.
   b. Apportion the total only between that part of the current period's production remaining in inventories at the end of the period and that part sold during the period.
   c. Carry forward the total to be offset by opposite balances in later periods.
   d. Charge or credit the total to the cost of goods sold during the period.

19. The method of project selection which considers the time value of money in a capital-budgeting decision is accomplished by computing the
   a. Accounting rate of return on initial investment.
   b. Accounting rate of return on average investment.
   c. Discounted cash flow.
   d. Payback period.

20. Given actual amounts of a semivariable cost for various levels of output, which of the following will give the most precise measure of the fixed and variable components?
   a. Bayesian statistics.
   b. Linear programming.
   c. Scattergram approach.
   d. Least squares method.

Number 2 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items relating to **Opinions of the Accounting Principles Board.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

21. Benefits under a pension plan that are **not** contingent upon an employee's continuing service are
    a. Granted under a plan of defined contribution.
    b. Based upon terminal funding.
    c. Actuarially unsound.
    d. Vested.

22. Which of the following is **not** affected by tax allocation within a period?
    a. Income before extraordinary items.
    b. Extraordinary items.
    c. Adjustments of prior periods.
    d. Operating revenues.

23. Under the comprehensive interperiod method of tax allocation, deferred taxes are determined on the basis of
    a. Tax rates in effect at the time the timing differences originate without adjustment for subsequent changes in tax rates.
    b. Tax rates expected to be in effect when the items giving rise to the timing differences reverse themselves.
    c. Net valuations of assets or liabilities.
    d. Averages determined on an industry-by-industry basis.

24. The accounting recognition of the benefit from a tax loss carryforward in most situations should be reported as
    a. A reduction of the loss in the year of the loss.
    b. A prior-period adjustment in whichever year the benefit is realized.
    c. An extraordinary item in the year in which the benefit is realized.
    d. An item on the retained-earnings statement, not the income statement.

25. At the time Hyman Corporation became a subsidiary of Duane Corporation, Hyman switched depreciation of its plant assets from the straight-line method to the sum-of-the-years'-digits method used by Duane. As to Hyman this change was a
    a. Change in an accounting estimate.
    b. Correction of an error.
    c. Change in accounting principle.
    d. Change in the reporting entity.

26. Manufacturers or dealer lessors sometimes sell or assign leases to third parties, usually independent financing companies. Where such a lease sale or assignment has occurred
    a. The lease **cannot** qualify for treatment as a sale even though it would have met the criteria for sale accounting treatment if only the lessor and the lessee had been involved.
    b. Involvement of the independent financing company does **not** disqualify the lease from sale accounting treatment if it otherwise qualifies for this treatment.
    c. The operating method of accounting for the lease transaction becomes mandatory.
    d. The financing method of accounting for the lease transaction becomes mandatory.

27. In 1973, Sterling Company acquired new delivery equipment. Consideration given was used, fully depreciated delivery equipment plus cash. Since the "gain" realized on the trade-in would have been small, the transaction was recorded by the income-tax method. In preparing a statement of changes in financial position on the working-capital basis, this transaction should be reflected by reporting the
    a. New asset value as an application of working capital and the book value of the old asset as a source of working capital.
    b. List price of the new asset as an application of working capital, the "gain" as a subtraction from net income, and the book value of the old asset as a source of working capital.
    c. Cash paid as an application of working capital and ignoring other facets of the transaction.
    d. Event in narrative form only.

28. An Accounting Principles Board Opinion is concerned with disclosure of accounting policies. A singular feature of this particular opinion is that it
    a. Calls for disclosure of every accounting policy followed by a reporting entity.
    b. Applies to immaterial items whereas most opinions are concerned solely with material items.
    c. Applies also to accounting policy disclosures by not-for-profit entities, whereas most opinions are concerned soley with accounting practices of profit-oriented entities.
    d. Prescribes a rigid format for the disclosure of policies to be reported upon.

29. When it is necessary to impute an interest rate in connection with a note payable, the rate should be
    a. Two-thirds of the prime rate effective at the time the obligation is incurred.
    b. The same as that used in the GNP Implicit Price Deflator.
    c. At least equal to the rate at which the debtor can obtain financing of a similar nature from other sources at the date of the transaction.
    d. As near zero as can be justified.

30. A revision in a factory overhead rate qualifies as an accounting change if the rate was revised because
   a. Of a change in the level of actual manufacturing costs incurred.
   b. Of a change in the costs considered to be elements of product cost.
   c. The standards had been set a number of years ago and had become somewhat obsolete.
   d. The method of producing the product had been changed.

31. Fisher Company sold equipment to Feind Company, taking in exchange a noninterest-bearing note, the face amount of which was in excess of the fair market value of the equipment. In a balance sheet prepared immediately after receipt of the note, Fisher should present the note at its face amount
   a. Without adjustment.
   b. Less implicit interest.
   c. Plus implicit interest.
   d. Plus the anticipated net earnings related to the note.

32. American Commercial Ventures, Inc., owns 25% of the common stock of an overseas corporation which has consistently operated profitably since the investment was made. Because the foreign corporation needs capital for growth, the foreign interests who own a majority of its stock have declared **no** dividends and evidently have **no** intent of changing this policy in the foreseeable future. In the light of these facts, American Commercial which uses the equity method to account for its investment
   a. Need **not** now make any provision for taxes on the foreign profits.
   b. Must accrue a provision for taxes on the foreign profits.
   c. Can, on a discretionary basis, provide for taxes on the foreign profits.
   d. Should recognize taxes only when and as foreign profits are remitted as dividends (with a resultant prior-period adjustment).

33. A manufacturer or dealer lessor should account for a lease transaction as a sale if collectibility of the lessee's payments is reasonably assured, there are **no** material cost uncertainties, and any of the following conditions exists, except one. Which of the following conditions will **invalidate** the sale presumption?
   a. Title passes to the lessee at **no** more than nominal cost by the end of the fixed noncancellable term of the lease.
   b. The sum of the present value of the lease payments and any related investment credit is equal to or greater than the normal selling price of the leased property.
   c. The fixed noncancellable term of the lease (excluding renewal options) is substantially equal to the remaining life of the property.
   d. The lessor retains a material contingent residual interest in the leased property.

34. When undistributed earnings of a subsidiary company have increased the pretax accounting income of a parent company because the latter consolidated the subsidiary or used the equity method to account for its investment
   a. Income tax allocation is necessary because there is an invariable presumption that undistributed earnings will ultimately be transferred to the parent.
   b. Maximum tax rates should be applied as a matter of conservatism if income tax allocation is applied.
   c. Income taxes need **not** be accrued where evidence shows the subsidiary will **not** remit undistributed earnings to the parent for an indefinite period.
   d. Generally accepted accounting principles have been violated.

35. When a stock option plan for employees is compensatory, the measurement date for determining compensation cost is the
   a. Date the option plan is adopted provided it precedes the date on which the options may first be exercised by less than one operating cycle.
   b. Date on which the options may first be exercised (if the first actual exercise is within the same operating period) or the date on which a recipient first exercises any of his options.
   c. First date on which are known both the number of shares that an individual employee is entitled to receive and the option or purchase price, if any.
   d. Date each option is granted.

36. When a balance-sheet account, which had **no** previous balance, is debited in connection with a compensatory stock option plan because the services relate to a future period, the balance of the account should be reported as a
   a. Deferred charge.
   b. Prepaid expense.
   c. Reduction of stockholders' equity.
   d. Deferred credit.

37. When debt is extinguished before its maturity date through a refunding transaction, any difference between the reacquisition price of outstanding debt and its net carrying amount per books should be
   a. Amortized over the remaining original life of the extinguished issue.
   b. Amortized over the life of the new issue.
   c. Recognized currently in income as a loss or gain.
   d. Treated as a prior-period adjustment.

38. Cole Corporation retired an issue of bonds before its maturity date through a direct exchange of securities. The best value for Cole to assign to the new issue of debt is the
   a. Maturity value of the new issue.
   b. Net carrying value of the old issue.
   c. Present value of the new issue.
   d. Maturity value of the old issue.

39. When the equity method of accounting for an investment in a subsidiary is used, dividends from the subsidiary should be accounted for by the parent corporation as
   a. Revenue unless paid from retained earnings of the subsidiary earned before the date of acquisition.
   b. Revenue so long as the dividends were declared from retained earnings.
   c. A reduction of the carrying value of the investment account.
   d. A deferred credit.

40. In 1973, Darby Company retired convertible bonds for which stock was issued pursuant to a conversion option. The exchange took place on an interest date, and except for the interest payment no money changed hands. In preparing a statement of changes in financial position on the working-capital basis, the exchange of securities should be
   a. Ignored because the "book value" method was used to record the exchange.
   b. Added to net income to arrive at working capital provided by operations.
   c. Subtracted from net income to arrive at working capital provided from operations.
   d. Reported as both a source (issuance of stock) and an application (retirement of bonds) of working capital.

Number 3 (Estimated time — 25 to 30 minutes)

Incurring long-term debt with an arrangement whereby lenders receive an option to buy common stock during all or a portion of the time the debt is outstanding is a frequently used corporate financing practice. In some situations the result is achieved through the issuance of convertible bonds; in others the debt instruments and the warrants to buy stock are separate.

Required:

a. 1. Describe the differences that exist in current accounting for original proceeds of the issuance of convertible bonds and of debt instruments with separate warrants to purchase common stock.
   2. Discuss the underlying rationale for the differences described in **a.** 1. above.
   3. Summarize the arguments which have been presented for the alternative accounting treatment.

b. At the start of the year AB Company issued $6,000,000 of 7% notes along with warrants to buy 400,000 shares of its $10 par value common stock at $18 per share. The notes mature over the next ten years starting one year from date of issuance with annual maturities of $600,000. At the time, AB had 3,200,000 shares of common stock outstanding and the market price was $23 per share. The company received $6,680,000 for the notes and the warrants. For AB Company, 7% was a relatively low borrowing rate. If offered alone, at this time, the notes would have been issued at a 20 to 24 percent discount. Prepare journal entries for the issuance of the notes and warrants for the cash consideration received.

Number 4 (Estimated time — 25 to 30 minutes)

One of your large clients, Edwards Chemical Corporation, engages in a substantial research and development (R & D) program aimed at keeping the company's product lines and production processes modern. This involves the development of new and improved products and processes and the exploration of areas which may or may not lead directly to discoveries of benefit to the company. Most of the research activities are conducted by technical personnel normally assigned to production departments although the research is done under the supervision of a full-time director of research. There is also a small full-time research staff working continuously on research projects. Nearly all research activity occurs in the company laboratory.

Largely because its R & D outlays are significant in amount and do not vary greatly in volume from one period to the next, Edwards' management has contended that its long-standing policy of expensing R & D costs as they are incurred is fundamentally sound and results in a fair presentation on the company's published financial statements. It would be fair to say that Edwards' R & D program has enjoyed better than average success and that the company is well regarded in its segment of a high-technology industry. The company's record of securing new patents and consistently high profit margins has been commented upon favorably by virtually all informed analysts who observe the industry closely.

Required:

a. Insofar as your client, Edwards Chemical Corporation, is concerned, how would you propose that the R & D costs be determined, accounted for, and reported in the financial statements? Your recommendations should emphasize historical-system aspects rather than budgetary control.

b. What deficiencies, if any, could have resulted from Edwards' accounting treatment of R & D costs in its financial statements?

c. The essence of management's argument in support of Edwards' treatment of R & D costs is the merit of "consistency." What other arguments, if any, can be cited in favor of its treatment?

Number 5 (Estimated time –– 25 to 30 minutes)

In order to effect an approximate matching of current costs with related sales revenue, the last-in, first-out (LIFO) method of pricing inventories has been developed.

Required:

a. Describe the establishment of and subsequent pricing procedures for each of the following LIFO inventory methods:

1. LIFO applied to units of product when the periodic inventory system is used.
2. Application of the dollar-value method to a retail LIFO inventory or to LIFO units of product (these applications are similar).

b. Discuss the specific advantages and disadvantages of using the dollar-value-LIFO applications. **Ignore income tax considerations.**

c. Discuss the general advantages and disadvantages claimed for LIFO methods. **Ignore income tax considerations.**

Number 6 (Estimated time ––25 to 30 minutes)

"Earnings per share" (EPS) is the most featured single financial statistic about modern corporations. Daily published quotations of stock prices have recently been expanded to include a "times earnings" figure for many securities which is based on EPS. Often the focus of analysts' discussions will be on the EPS of the corporations receiving their attention.

Required:

a. Explain how dividends or dividend requirements on any class of preferred stock that may be outstanding affect the computation of EPS.

b. One of the technical procedures applicable in EPS computations is the "treasury-stock method."

1. Briefly describe the circumstances under which it might be appropriate to apply the treasury-stock method.
2. There is a limit to the extent to which the treasury-stock method is applicable. Indicate what this limit is and give a succinct indication of the procedures that should be followed beyond the treasury-stock limits.

c. Under some circumstances convertible debentures would be considered "common stock equivalents" while under other circumstances they would not.

1. When is it proper to treat convertible debentures as common stock equivalents? What is the effect on computation of EPS in such cases?
2. In case convertible debentures are not considered as common stock equivalents, explain how they are handled for purposes of EPS computations.

Number 7 (Estimated time –– 25 to 30 minutes)

Cost-volume-earnings analysis (break-even analysis) is used to determine and express the interrelationships of different volumes of activity (sales), costs, sales prices, and sales mix to earnings. More specifically, the analysis is concerned with what will be the effect on earnings of changes in sales volume, sales prices, sales mix, and costs.

Required:

a. Certain terms are fundamental to cost-volume-earnings analysis. Explain the meaning of each of the following terms:

1. Fixed costs.
2. Variable costs.
3. Relevant range.
4. Break-even point.
5. Margin of safety.
6. Sales mix.

b. Several assumptions are implicit in cost-volume-earnings analysis. What are these assumptions?

c. In a recent period Zero Company had the following experience:

Sales (10,000 units @ $200)			$2,000,000
	Fixed	*Variable*	
Costs:			
Direct material	$ –	$ 200,000	
Direct labor	–	400,000	
Factory overhead	160,000	600,000	
Administrative expenses	180,000	80,000	
Other expenses	200,000	120,000	
Total costs	$540,000	$1,400,000	1,940,000
Net income			$ 60,000

Each item below is independent.

1. Calculate the break-even point for Zero in terms of units and sales dollars. Show your calculations.
2. What sales volume would be required to generate a net income of $96,000? Show your calculations.
3. What is the break-even point if management makes a decision which increases fixed costs by $18,000? Show your calculations.

Uniform Certified Public Accountant Examination

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING PRACTICE -- PART I

November 6, 1974; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	40	50
No. 2	40	50
No. 3	50	60
No. 4	50	60
No. 5	40	50
Total	220	270

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, number the pages in sequence for that question with the lead schedule first, followed by supporting computations. For instance, if you use three pages for Question No. 3, you should show Question 3, Page 1 of 3, Page 2 of 3, and Page 3 of 3. The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. **Enclose all scratch sheets.** Failure to enclose scratch sheets may result in loss of grading points. Scratch sheets need not have page numbers, but you should show the question number and place them immediately following the question to which they relate.

3. Fourteen-column sheets should not be folded until all sheets, both wide and narrow, are placed in the proper sequence and fastened together at the top left corner. All fourteen-column sheets should then be wrapped around the back of the papers.

4. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 40 to 50 minutes)

Instructions

Select the **best** answer for each of the following items relating to the **federal income taxation of corporations and partnerships**. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. The answers should be selected in accordance with the **current Internal Revenue Code and Tax Regulations. Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

95. What is the tax rate paid by corporations on the first $25,000 of taxable income?
   a. 15%.
   b. 20%.
   c. 22%.
   d. 25%.
   e. None of the above.

Answer Sheet

95. a. :::::::: b. :::::::: c. d. :::::::: e. ::::::::

Items to be Answered

Items 1 and 2 are based on the following information:

In its first year of operation, 1973, Bell Corporation had net short-term capital gains of $3,000 and net long-term capital losses of $8,000.

1. What is Bell's 1973 net capital-loss deduction, and what is the capital-loss carryover to 1974, respectively?
   a. $0 and $5,000.
   b. $1,000 and $3,000.
   c. $1,000 and $4,000.
   d. $2,500 and $2,500.
   e. None of the above.

2. How will the 1973 capital-loss carryover be treated in Bell's 1974 income tax return?
   a. Ordinary loss.
   b. Section 1231 loss.
   c. Long-term capital loss.
   d. Short-term capital loss.
   e. None of the above.

3. Diane Corporation sold a building in 1973 that was used in its business and depreciated using straight-line depreciation. The selling price on November 30, 1973, was $75,000. The cost on January 2, 1965, was $100,000. The total gain on the sale was $11,000. What portion of this gain is recaptured as ordinary income, and what portion is treated as Section 1231 gain, respectively?
   a. $0 and $11,000.
   b. $1,320 and $9,680.
   c. $5,500 and $5,500.
   d. $11,000 and $0.
   e. None of the above.

4. On October 1, 1973, Helma Corporation traded a business automobile with an adjusted basis of $1,500 for a new automobile to be used in the business. In addition Helma paid $3,000 in cash. The new automobile has an estimated life of four years and no estimated salvage. The corporation is on a calendar year and had 1973 taxable income of $80,000. The 1973 investment tax credit allowed on this acquisition should be
   a. $70.
   b. $105.
   c. $210.
   d. $315.
   e. None of the above.

5. Pursuant to a plan of reorganization in 1973, Mr. Jack exchanged 500 shares of Zee Corporation common stock that he had purchased for $50,000 for 850 shares of Dal Corporation common stock having a fair market value of $58,000. What is Mr. Jack's recognized gain on this exchange, and what is his basis for the Dal stock, respectively?
   a. $0 and $50,000.
   b. $8,000 and $50,000.
   c. $0 and $58,000.
   d. $8,000 and $58,000.
   e. None of the above.

6. For the calendar year 1973, Pat Corporation had gross income of $140,000 and deductible business expenses of $50,000, exclusive of capital gains and losses. Capital gains and losses were as follows:

Net short-term capital loss	$ (3,000)
Net long-term capital gain	16,000
Net capital gain	$13,000

Based on these facts, what is the **least** federal income tax that Pat should pay on its 1973 income?
   a. $36,700.
   b. $39,820.
   c. $40,600.
   d. $42,940.
   e. None of the above.

7. During 1973, the Mavis Corporation sold property to one of its stockholders, Don Corporation, for $1,000. The property had a fair market value of $2,300 and an adjusted basis to Mavis of $1,500. This transaction is considered an income distribution from Mavis to Don. How much of this distribution is taxable as a dividend to Don before considering the dividends-received deduction?
   a. $0.
   b. $500.
   c. $800.
   d. $1,300.
   e. None of the above.

8. During 1973, Mikey Corporation exchanged an old machine used in its business for a similar new machine to be used in its business. The following chart summarizes the relevant data on the date of exchange:

	Adjusted Basis	*Fair Market Value*
Old Machine (to Mikey)	$4,000	$5,500
New Machine (to the seller)	$3,000	$3,500

As part of the exchange, Mikey Corporation received $2,000 cash. What is the recognized gain on this exchange, and what is the tax basis of the new machine to Mikey, respectively?
   a. $0 and $1,000.
   b. $0 and $2,000.
   c. $1,500 and $3,500.
   d. $2,000 and $4,000.
   e. None of the above.

9. Which one of the following items would cause taxable income to be less than book (accounting) income?
   a. Goodwill amortization.
   b. Penalty for late payment of prior year's income tax.
   c. Excess depreciation where accelerated depreciation is used per books, straight-line depreciation for tax purposes, and it is the last year of all assets' lives.
   d. Charitable contributions in excess of the maximum limit prescribed for federal income tax purposes.
   e. None of the above.

10. Jerry owns 60% of the outstanding stock of Mitch Corporation. During 1973, Jerry sold Mitch a machine for $60,000 that had an adjusted tax basis of $68,000. For tax purposes, what should Jerry report for 1973?
   a. $0 recognized loss.
   b. $8,000 ordinary loss.
   c. $8,000 Section 1231 loss.
   d. $8,000 capital loss.
   e. None of the above.

11. Gary Corporation had 1973 gross income of $90,000 including $50,000 of dividends received from a non-affiliated domestic corporation. Gary had business deductions of $43,000 and a net operating loss carryover of $5,000. What is Gary's 1973 dividends-received deduction?
   a. $35,700.
   b. $39,950.
   c. $42,500.
   d. $50,000.
   e. None of the above.

12. Lewis and Clark are partners who share profits and losses in a ratio of 2:1, respectively. For 1973, the partnership tax return showed a net short-term capital loss of $3,000 and a net long-term capital gain of $15,000. Lewis also had a personal net short-term capital loss of $2,000. Using the regular method, what is the net capital gain that should be included in Lewis' taxable income on his 1973 individual income tax return?
   a. $3,000.
   b. $3,500.
   c. $4,000.
   d. $6,667.
   e. None of the above.

13. The partnership of Brown, Gold, and Rose shares profits and losses in a ratio of 5:4:1, respectively. The tax basis of each partner in the partnership as of December 31, 1973, follows:

Brown	$8,180
Gold	$4,350
Rose	$ 300

The partnership incurred an operating loss of $10,000 for 1973. This loss is **not** reflected in the above tax basis figures. As a result of this loss, Brown, Gold, and Rose should deduct respectively on their 1973 individual returns
   a. $5,000, $4,000, and $300.
   b. $5,000, $4,000, and $1,000.
   c. $5,350, $4,350, and $300.
   d. $5,389, $4,311, and $300.
   e. None of the above.

14. During 1973, Wayne sold the interest he had held for five years in the Alco Partnership for $15,000 cash. The buyer also assumed Wayne's $2,000 share of the partnership liabilities. Wayne's tax basis in the partnership was $11,000. There were no unrealized receivables or appreciated inventories involved in this transaction. What is Wayne's gain on the sale of his partnership interest in Alco?
   a. $2,000 ordinary gain.
   b. $2,000 long-term capital gain.
   c. $4,000 long-term capital gain.
   d. $6,000 long-term capital gain.
   e. None of the above.

15. Howard Harper has conducted his hardware-store business as a sole proprietorship for twenty-five years. On May 1, 1973, he gave a one-fourth interest in this business to his son, Lanny. After the transfer of this one-fourth interest, under what circumstances would the business be considered a partnership for federal income tax purposes?
   a. Under **no** circumstances.
   b. Only if the son is a bona fide owner of the interest which was said to have been transferred to him.
   c. Only if the son gives his father a promissory note for the value of the interest transferred to him.
   d. Only if the son works in the hardware store.
   e. None of the above.

16. During 1973, Norman contributed property held more than six months to the MaryAnn Partnership for a 40% interest. The total capital after his contribution was $50,000. His tax basis in the property was $8,000, and it had a fair market value of $10,000 at the time of the contribution to the partnership. What gain or loss should Norman report on the contribution of his property to the partnership?
   a. No gain or loss.
   b. $2,000 long-term capital gain.
   c. $12,000 long-term capital gain.
   d. $12,000 long-term capital gain of which $10,000 is deferred.
   e. None of the above.

Number 2 (Estimated time — 40 to 50 minutes)

Instructions

Select the **best** answer for each of the following items which relate to a **variety of municipal and nonprofit hospital accounting problems.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

Items 17 through 20 are based on the following information:

The following related entries were recorded in sequence in the general fund of a municipality:

1.	Encumbrances	$12,000	
	Reserve for encumbrances		$12,000
2.	Reserve for encumbrances	12,000	
	Encumbrances		12,000
3.	Expenditures	12,350	
	Vouchers payable		12,350

17. The sequence of entries indicates that
   a. An adverse event was foreseen and a reserve of $12,000 was created; later the reserve was cancelled and a liability for the item was acknowledged.
   b. An order was placed for goods or services estimated to cost $12,000; the actual cost was $12,350 for which a liability was acknowledged upon receipt.
   c. Encumbrances were anticipated but later failed to materialize and were reversed. A liability of $12,350 was incurred.
   d. The first entry was erroneous and was reversed; a liability of $12,350 was acknowledged.

18. Entries similar to those for the general fund may also appear on the books of the municipality's
   a. General fixed-assets group.
   b. General bonded-debt group.
   c. Trust fund.
   d. Special-revenue fund.

19. Assuming appropriate governmental accounting principles were followed, the entries
   a. Occurred in the same fiscal period.
   b. Did **not** occur in the same fiscal period.
   c. Could have occurred in the same fiscal period, but it is impossible to be sure of this.
   d. Reflect the equivalent of a "prior period adjustment" had the entity concerned been one operated for profit.

20. Immediately after entry number one was recorded, the municipality had a balanced general fund budget for all transactions. What would be the effect of recording entries two and three?
   a. **Not** change the balanced condition of the budget.
   b. Cause the municipality to show a surplus.
   c. Cause the municipality to show a deficit.
   d. **Not** affect the current budget but would affect the budget of the following fiscal period.

Items 21 through 29 refer to transactions of Brockton City.

21. In preparing the general-fund budget of Brockton City for the forthcoming fiscal year the city council appropriated a sum greater than expected revenues. This action of the council will result in
   a. A cash overdraft during that fiscal year.
   b. An increase in encumbrances by the end of that fiscal year.
   c. A decrease in the fund balance.
   d. A necessity for compensatory offsetting action in the debt-service fund.

22. Brockton City's water utility, which is an enterprise fund, submits a bill for $9,000 to the general fund for water service supplied to city departments and agencies. Submission of this bill would result in
    a. Creation of balances which will be eliminated on the city's combined balance sheet.
    b. Recognition of revenue by the water-utility fund and of an expenditure by the general fund.
    c. Recognition of an encumbrance by both the water-utility fund and the general fund.
    d. Creation of a balance which will be eliminated on the city's combined statement of changes in fund balances.

23. Brockton City's water utility, which is an enterprise fund, transferred land and a building to the general city administration for public use at **no** charge to the city. The land was carried on the water-utility books at $4,000 and the building at a cost of $30,000 on which $23,000 depreciation had been recorded. In the year of the transfer what would be the effect of the transaction?
    a. Reduce retained earnings of the water utility by $11,000 and increase the fund balance of the general fund by $11,000.
    b. Reduce retained earnings of the water utility by $11,000 and increase the total assets in the general fixed-assets group by $11,000.
    c. Reduce retained earnings of the water utility by $11,000 and increase the total assets in the general fixed-assets group by $34,000.
    d. Have **no** effect on a combined balance sheet for the city.

24. Brockton City has approved a special-assessment project in accordance with applicable laws. Total assessments of $500,000, including 10% for the city's share of the cost, have been levied. The levy will be collected from property owners in ten equal annual installments commencing with the current year. Recognition of the approval and levy will result in entries of
    a. $500,000 in the special-assessment fund and $50,000 in the general fund.
    b. $450,000 in the special-assessment fund and $50,000 in the general fund.
    c. $50,000 in the special-assessment fund and $50,000 in the general fund.
    d. $50,000 in the special-assessment fund and **no** entry in the general fund.

25. What would be the effect on the general-fund balance in the current fiscal year of recording a $15,000 purchase for a new fire truck out of general-fund resources, for which a $14,600 encumbrance had been recorded in the general fund in the previous fiscal year?
    a. Reduce the general-fund balance $15,000.
    b. Reduce the general-fund balance $14,600.
    c. Reduce the general-fund balance $400.
    d. Have **no** effect on the general-fund balance.

26. Brockton City's debt-service fund (for term bonds) recorded required additions and required earnings for the current fiscal year of $15,000 and $7,000, respectively. The actual revenues and interest earnings were $16,000 and $6,500, respectively. What are the necessary entries to record the year's actual additions and earnings in the debt-service fund and in the general long-term-debt group, respectively?
    a. $22,500 and $22,000.
    b. $22,000 and $22,000.
    c. $22,500 and $22,500.
    d. $22,500 and **no** entry.

27. Brockton City serves as collecting agency for the local independent school district and for a local water district. For this purpose, Brockton has created a single agency fund and charges the other entities a fee of 1% of the gross amounts collected. (The service fee is treated as general-fund revenue.) During the latest fiscal year a gross amount of $268,000 was collected for the independent school district and $80,000 for the water district. As a consequence of the foregoing, Brockton's general fund should
    a. Recognize receipts of $348,000.
    b. Recognize receipts of $344,520.
    c. Record revenue of $3,480.
    d. Record encumbrances of $344,520.

28. When Brockton City realized $1,020,000 from the sale of a $1,000,000 bond issue, the entry in its capital-project fund was

Cash	$1,020,000	
Revenues		$1,000,000
Premium on bonds		20,000

Recording the transaction in this manner indicates that
    a. The $20,000 **cannot** be used for the designated purpose of the fund but must be transferred to another fund.
    b. The full $1,020,000 can be used by the capital-project fund to accomplish its purpose.
    c. The nominal rate of interest on the bonds is below the market rate for bonds of such term and risk.
    d. A safety factor is being set aside to cover possible contract defaults on the construction.

29. What will be the balance-sheet effect of recording $50,000 of depreciation in the accounts of a utility, an enterprise fund, owned by Brockton City?
    a. Reduce total assets of the utility fund and the general fixed-assets group by $50,000.
    b. Reduce total assets of the utility fund by $50,000 but have **no** effect on the general fixed-assets group.
    c. Reduce total assets of the general fixed-assets group by $50,000 but have **no** effect on assets of the utility fund.
    d. Have **no** effect on total assets of either the utility fund or the general fixed-assets group.

Items 30 through 33 refer to the accounts of a large nonprofit hospital which properly maintains four funds: operating, special purpose, endowment, and plant.

30. The endowment fund consists of several small endowments, each for a special purpose. The hospital treasurer has determined that it would be legally possible and more efficient to "pool" the assets and allocate the resultant revenue. The soundest basis on which to allocate revenue after assets are "pooled" and comply with the special purposes of each endowment would be to
    a. Determine market values of securities or other assets comprising each endowment at the time of transfer to the pool and credit revenue to each endowment on that pro rata basis.
    b. Determine book value of each endowment at the time of transfer to the pool and credit revenue to each endowment on that pro rata basis.
    c. Apportion future revenue in the moving-average ratio that the various endowments have earned revenue in the past.
    d. Ask the trustee who administers the pooled assets to make the determination since he is in a position to know which assets are making the greatest contribution.

31. How should charity service, contractual adjustments, and bad debts be classified in the statement of revenues and expenses for the hospital?
    a. All three should be treated as expenses.
    b. All three should be treated as deductions from patient-service revenues.
    c. Charity service and contractual adjustments should be treated as revenue deductions while bad debts should be treated as an expense.
    d. Charity service and bad debts should be treated as expenses while contractual adjustments should be treated as a revenue deduction.

32. Depreciation on some hospital fixed assets, referred to as "minor equipment," is **not** accounted for in the conventional manner. How is depreciation with respect to these assets accounted for?
    a. Ignored on the basis of immateriality.
    b. Handled in essentially the same manner as would be the case if the assets were assigned to the activities of a city and were accounted for in its general fund.
    c. Determined periodically by inventorying minor equipment and writing the assets down to their value at the inventory date.
    d. Recognized only when minor equipment is replaced.

33. To assure the availability of money for improvements, replacement, and expansion of plant, it would be most desirable for the hospital to
    a. Use accelerated depreciation to provide adequate funds for eventual replacement.
    b. Use the retirement or replacement system of depreciation to provide adequate funds.
    c. Sell assets at the earliest opportunity.
    d. Transfer cash from the operating fund to the plant fund in amounts at least equal to the periodic depreciation charges.

Number 3 (Estimated time — 50 to 60 minutes)

David Construction, Inc., builds heavy construction equipment for commercial and government purposes. Because of two new contracts and the anticipated purchase of new equipment, the management needs certain projections for the next three years. You have been requested to prepare these projections.

You have acquired the following information from the company's records and personnel.

- David Construction uses the completed-contract method of accounting whereby construction costs are capitalized until the contract is completed. Since all general and administrative expenses can be identified with a particular contract, they also are capitalized until the contract is completed.
- David's December 31, 1973, balance sheet follows:

Assets

Cash		$ 72,000
Due on contracts		–
Costs of uncompleted contracts in excess of billings		–
Plant and equipment	$2,800,000	
Less accumulated depreciation	129,600	2,670,400
Total		$2,742,400

Liabilities and Stockholders' Equity

Loans payable	$ –
Accrued construction costs	612,400
Accrued income tax payable	65,000
Common stock ($10 par value)	500,000
Paid in capital	100,000
Retained earnings	1,465,000
Total	$2,742,400

• Two contracts will be started in 1974 – Contract A and Contract B. Contract A and Contract B are expected to be completed in December 1975 and December 1976, respectively. No other contracts will be started until after Contracts A and B are completed. All other outstanding contracts had been completed in 1973.

• Total estimated revenue for Contract A is \$2,000,000 and for Contract B is \$1,500,000. The estimated cash collections per year follow:

	1974	*1975*	*1976*
Contract A	\$ 800,000	\$1,200,000	\$ –
Contract B	300,000	450,000	750,000
	\$1,100,000	\$1,650,000	\$750,000

• Estimated construction costs to be incurred per contract, per year follow:

	Contract A	*Contract B*
1974	\$ 720,000	\$ 250,000
1975	1,000,000	400,000
1976	–	650,000
	\$1,720,000	\$1,300,000

• Depreciation expense is included in these estimated construction costs. For 1974, 10% of the estimated construction costs represents depreciation expense. For 1975 and 1976, 15% of the estimated construction costs represents depreciation expense. The cash portion of these estimated construction costs is paid as follows: 70% in the year incurred and 30% in the following year.

• Total general and administrative expenses (not included in construction costs) consist of a fixed portion each year for each contract, and a variable portion which is a function of cash collected each year. For the two prior years, cash collected and total general and administrative expenses (based on one contract each year) were as follows:

	Cash Collected	*Total General and Administrative Expenses*
1973	\$1,350,000	\$27,250
1972	1,180,000	24,700

These general and administrative expenses all represent cash expenses and are paid in the year incurred.

• Dividends are expected to be distributed as follows:

1974	Stock – 10% of common shares outstanding (estimated fair market value is \$15 per share).
1975	Stock split – 2 for 1 (par value to be reduced to \$5 per share).
1976	Cash – \$1.00 per share.

• David will acquire a new asset in 1975 for \$700,000 and plans to pay for it that year.

• When the cash balance falls below \$70,000, David obtains short-term loans in multiples of \$10,000. For purposes of this problem, **ignore interest on short-term loans and ignore any repayments on these loans.**

• Assume income taxes are paid in full the following year.

Required:

a. Prepare projected income statements for each of the calendar years 1975 and 1976 (when contracts are to be completed). The income tax rate is 40%, and the company uses the same methods for accounting and tax purposes.

b. Prepare cash budgets for each of the calendar years 1974, 1975, and 1976. The budgets should follow this format:

Cash (beginning of year)	\$
Plus: collections	
Less: disbursements (enumerated)	
Plus: borrowing (if any)	
Cash (end of year)	\$

Number 4 (Estimated time — 50 to 60 minutes)

Number 4 consists of three unrelated parts.

Part a. The Helper Corporation manufactures one product and accounts for costs by a job-order-cost system. You have obtained the following information for the year ended December 31, 1973, from the Corporation's books and records:

- Total manufacturing cost added during 1973 (sometimes called cost to manufacture) was $1,000,000 based on actual direct material, actual direct labor, and applied factory overhead on actual direct labor dollars.
- Cost of goods manufactured was $970,000 also based on actual direct material, actual direct labor, and applied factory overhead.
- Factory overhead was applied to work in process at 75% of direct labor dollars. Applied factory overhead for the year was 27% of the total manufacturing cost.
- **Beginning work-in-process inventory, January 1,** was 80% of ending work-in-process inventory, December 31.

Required:

Prepare a formal statement of cost of goods manufactured for the year ended December 31, 1973, for Helper Corporation. Use actual direct material used, actual direct labor, and applied factory overhead. Show supporting computations in good form.

Part b. Poole, Inc., produces a chemical compound by a unique chemical process which Poole has divided into two departments, A and B, for accounting purposes. The process functions as follows:

- The formula for the chemical compound requires one pound of Chemical X and one pound of Chemical Y. In the simplest sense, one pound of Chemical X is processed in Department A and transferred to Department B for further processing where one pound of Chemical Y is added when the process is 50% complete. When the processing is complete in Department B, the finished chemical compound is transferred to finished goods. The process is continuous, operating twenty-four hours a day.
- **Normal spoilage occurs in Department A. Five** percent of Chemical X is lost in the first few seconds of processing.
- No spoilage occurs in Department B.
- In Department A conversion costs are incurred uniformly throughout the process and are allocated to good pounds produced because spoilage is normal.
- In Department B conversion costs are allocated equally to each equivalent pound of output.
- **Poole's unit of measure for work-in-process and finished-goods inventories is pounds.**
- The following data are available for the month of October 1974:

	Department A	*Department B*
Work in process, October 1	8,000 pounds	10,000 pounds
Stage of completion of beginning inventory (one batch per department)	3/4	3/10
Started or transferred in	50,000 pounds	?
Transferred out	46,500 good pounds	?
Work in process, October 31	?	?
Stage of completion of ending inventory (one batch per department)	1/3	1/5
Total equivalent pounds of material added in Department B	—	44,500 pounds

Required:

Prepare schedules computing equivalent unspoiled pounds of production (materials and conversion costs) for Department A and for Department B for the month of October 1974 using the first-in, first-out method for inventory costing.

Part c. The Harrison Corporation produces three products – Alpha, Beta, and Gamma. Alpha and Gamma are joint products while Beta is a by-product of Alpha. No joint cost is to be allocated to the by-product. The production processes for a given year are as follows:

- In Department One, 110,000 pounds of raw material, Rho, are processed at a total cost of $120,000. After processing in Department One, 60% of the units are transferred to Department Two and 40% of the units (now Gamma) are transferred to Department Three.
- In Department Two, the material is further processed at a total additional cost of $38,000. Seventy percent of the units (now Alpha) are transferred to Department Four and 30% emerge as Beta, the by-product, to be sold at $1.20 per pound. Selling expenses related to disposing of Beta are $8,100.
- In Department Four, Alpha is processed at a total additional cost of $23,660. After this processing, Alpha is ready for sale at $5 per pound.
- In Department Three, Gamma is processed at a total additional cost of $165,000. In this department, a normal loss of units of Gamma occurs which equals 10% of the good output of Gamma. The remaining good output of Gamma is then sold for $12 per pound.

Required:

1. Prepare a schedule showing the allocation of the $120,000 joint cost between Alpha and Gamma using the relative sales value approach. The net realizable value of Beta should be treated as an addition to the sales value of Alpha.

2. Independent of your answer to requirement 1, assume that $102,000 of total joint costs were appropriately allocated to Alpha. Assume also that there were 48,000 pounds of Alpha and 20,000 pounds of Beta available to sell. Prepare a statement of gross margin for Alpha using the following facts:

- During the year, sales of Alpha were 80% of the pounds available for sale. There was no beginning inventory.
- The net realizable value of Beta available for sale is to be deducted from the cost of producing Alpha. The ending inventory of Alpha is to be based on the net cost of production.
- All other cost, selling-price, and selling-expense data are those presented in the facts under **Part c.**

Number 5 (Estimated time –– 40 to 50 minutes)

Number 5 consists of two unrelated parts.

Part a. Homer, Inc., has two fire insurance policies. Policy A covers the office building at a face value of $360,000 and the furniture and fixtures at a face value of $108,000. Policy B covers only the office building at an additional face value of $140,000. Each policy is with a different insurance company. A fire caused losses to the office building and the furniture and fixtures. The relevant data are summarized below:

	Furniture and Fixtures	*Office Building*	
Insurance policy	A	A	B
Fair market value of the property **before** fire	$150,000	$700,000	$700,000
Fair market value of the property **after** fire	$ 20,000	$420,000	$420,000
Face of insurance policy	$108,000	$360,000	$140,000
Co-insurance requirement	80%	80%	80%

Required:

Compute the amount due from **each** insurance company for the loss on **each** asset category. Show computations in good form.

Part b. Thompson Corporation, a manufacturer of steel products, began operations on October 1, 1972. The accounting department of Thompson has started the fixed-asset and depreciation schedule presented on page 11. You have been asked to assist in completing this schedule. In addition to ascertaining that the data already on the schedule are correct, you have obtained the following information from the company's records and personnel:

- Depreciation is computed from the first of the month of acquisition to the first of the month of disposition.
- Land A and Building A were acquired from a predecessor corporation. Thompson paid $812,500 for the land and building together. At the time of acquisition, the land had an appraised value of $72,000 and the building had an appraised value of $828,000.
- Land B was acquired on October 2, 1972, in exchange for 3,000 newly issued shares of Thompson's common stock. At the date of acquisition, the stock had a par value of $5 per share and a fair value of $25 per share. During October 1972, Thompson paid $10,400 to demolish an existing building on this land so it could construct a new building.
- Construction of Building B on the newly acquired land began on October 1, 1973. By September 30, 1974, Thompson had paid $210,000 of the estimated total construction costs of $300,000. Estimated completion and occupancy are July 1975.
- Certain equipment was donated to the corporation by a local university. An independent appraisal of the equipment when donated placed the fair value at $16,000 and the salvage value at $2,000.
- Machinery A's total cost of $110,000 includes installation expense of $550 and normal repairs and maintenance of $11,000. Salvage value is estimated as $5,500. Machinery A was sold on February 1, 1974.
- On October 1, 1973, Machinery B was acquired with a down payment of $4,000 and the remaining payments to be made in ten annual installments of $4,000 each beginning October 1, 1974. The prevailing interest rate was 8%. The following data were abstracted from present-value tables:

Present value of $1.00 at 8%	
10 years	.463
11 years	.429
15 years	.315

Present value of annuity of $1.00 in arrears at 8%	
10 years	6.710
11 years	7.139
15 years	8.559

Thompson Corporation
FIXED ASSET AND DEPRECIATION SCHEDULE
For Fiscal Years Ended September 30, 1973, and September 30, 1974

Assets	*Acquisition Date*	*Cost*	*Salvage*	*Depreciation Method*	*Estimated Life in Years*	*Depreciation Expense Year Ended September 30, 1973*	*Depreciation Expense Year Ended September 30, 1974*
Land A	October 1, 1972	$ **(1)**	N/A	N/A	N/A	N/A	N/A
Building A	October 1, 1972	**(2)**	$47,500	Straight Line	**(3)**	$14,000	$ **(4)**
Land B	October 2, 1972	**(5)**	N/A	N/A	N/A	N/A	N/A
Building B	Under Construction	210,000 to date	–	Straight Line	Thirty	–	**(6)**
Donated Equipment	October 2, 1972	**(7)**	2,000	150% Declining Balance	Ten	**(8)**	**(9)**
Machinery A	October 2, 1972	**(10)**	5,500	Sum of Years' Digits	Ten	**(11)**	**(12)**
Machinery B	October 1, 1973	**(13)**	–	Straight Line	Fifteen	–	**(14)**

N/A –– Not applicable

Required:

Number your answer sheet from 1 to 14. For each numbered item on the preceding schedule, supply the correct amount next to the corresponding number on your answer sheet. Round each answer to the nearest dollar. **Do not recopy the schedule.** Show supporting computations in good form.

Uniform Certified Public Accountant Examination

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING PRACTICE — PART II

November 7, 1974; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

	Estimated Minutes	
All questions are required:	*Minimum*	*Maximum*
No. 1	40	50
No. 2	50	60
No. 3	40	50
No. 4	50	60
No. 5	40	50
Total	220	270

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, number the pages in sequence for that question with the lead schedule first, followed by supporting computations. For instance, if you use three pages for Question No. 3, you should show **Question 3, Page 1 of 3, Page 2 of 3, and Page 3 of 3.** The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. **Enclosed all scratch sheets** Failure to enclose scratch sheets may result in loss of grading points. Scratch sheets need not have page numbers, but you should show the question number and place them immediately following the question to which they relate.

3. Fourteen-column sheets should not be folded until all sheets, both wide and narrow, are placed in the proper sequence and fastened together at the top left corner. All fourteen-column sheets should then be wrapped around the back of the papers.

4. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time -- 40 to 50 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of financial-accounting problems.** Use a soft pencil, preferably No 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to \$5,260,000; sales returns and allowances reduced the amounts owed by \$160,000. Net sales last year for Baker Company were
   a. \$5,260,000.
   b. \$5,200,000.
   c. \$5,100,000.
   d. \$4,800,000.

Answer Sheet

97. a. :::::::::: b. :::::::::: c. ■ d. ::::::::::

Items to be Answered

1. George Company maintains two checking accounts. A special account is used for the weekly payroll only, and the general account is used for all other disbursements. Every week, a check in the amount of the net payroll is drawn on the general account and deposited in the payroll account. The company maintains a \$5,000 minimum balance in the payroll account. On a monthly bank reconciliation, the payroll account should
   a. Show a zero balance per the bank statement.
   b. Show a \$5,000 balance per the bank statement.
   c. Reconcile to \$5,000.
   d. Be reconciled jointly with the general account in a single reconciliation.

2. A company has net income of \$900,000 for computation of primary earnings per share (EPS) and net income of \$960,000 for computation of fully diluted EPS. Its capital structure consists only of common stock and \$2,000,000 of bonds convertible into common stock, all outstanding all year. The bonds were issued at face value and are **not** common stock equivalents. Assuming an effective income tax rate of 40%, what is the stated interest rate on these bonds?
   a. 3%.
   b. 5%.
   c. 7.5%.
   d. **Cannot** be determined from the information given.

Items 3, 4 and 5 are based on the following information:

Shaid Corporation issued \$2,000,000 of 6%, ten-year convertible bonds on June 1, 1973, at 98 plus accrued interest. The bonds were dated April 1, 1973, with interest payable April 1 and October 1. Bond discount is amortized semi-annually on a straight-line basis.

On April 1, 1974, \$500,000 of these bonds were converted into 500 shares of \$20 par value common stock. Accrued interest was paid in cash at the time of conversion.

3. If "accrued interest payable" were credited when the bonds were issued, what should be the amount of the debit to "interest expense" on October 1, 1973?
   a. Approximately \$38,644.
   b. Exactly \$40,000.
   c. Approximately \$41,356.
   d. Exactly \$60,000.

4. What should be the amount of the unamortized bond discount on April 1, 1974, relating to the bonds converted?
   a. Approximately \$8,983.
   b. Approximately \$9,153.
   c. Exactly \$10,000.
   d. Approximately \$11,017.

5. What was the effective interest rate on the bonds when they were issued?
   a. 6%.
   b. Above 6%.
   c. Below 6%.
   d. **Cannot** be determined from the information given.

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6. Earth Corporation's partial income statement after its first year of operations is as follows:

Income before tax		\$1,000,000
Federal income tax payable	\$416,000	
Less deferred income tax	(16,000)	
Income tax expense		400,000
Net income after tax		\$600,000

Earth estimates its annual warranty expense as a percentage of sales. The amount charged to warranty expense on its books this year was \$380,000. No other differences existed between book income and taxable income except the warranty expense.

Assuming a 40% income tax rate, what amount was actually paid this year on the corporation's warranty?
   a. \$340,000.
   b. \$380,000.
   c. \$400,000.
   d. \$420,000.

7. The Wisper Company provides an incentive compensation plan under which its president is to receive a bonus equal to 10% of the company's income in excess of $100,000 before deducting income tax but after deducting the bonus. If income before income tax and bonus is $320,000 and the effective tax rate is 40%, the amount of the bonus should be
   a. $20,000.
   b. $22,000.
   c. $32,000.
   d. $44,000.

Items 8 and 9 are based on the following information:

The following balance sheet is for the partnership of Able, Bayer, and Cain which shares profits and losses in the ratio of 4:4:2, respectively.

Assets

Cash	$ 20,000
Other assets	180,000
	$200,000

Liabilities and Capital

Liabilities	$50,000
Able, Capital	37,000
Bayer, Capital	65,000
Cain, Capital	48,000
	$200,000

8. The original partnership was dissolved when its assets, liabilities, and capital were as shown on the above balance sheet and liquidated by selling assets in installments. The first sale of noncash assets having a book value of $90,000 realized $50,000, and all cash available after settlement with creditors was distributed. How much cash should the respective partners receive (to the nearest dollar)?
   a. Able $8,000; Bayer $8,000; Cain $4,000.
   b. Able $6,667; Bayer $6,667; Cain $6,666.
   c. Able $0; Bayer $13,333; Cain $6,667.
   d. Able $0; Bayer $3,000; Cain $17,000.

9. Independent of item 8, assume that the assets and liabilities are fairly valued on the balance sheet above. The partnership wishes to admit Day as a partner with a one-sixth interest without recording goodwill or bonus. What amount of cash or other assets should Day contribute?
   a. $30,000.
   b. $33,333.
   c. $36,000.
   d. $40,000.

Items 10 and 11 are based on the following information:

Apex Company acquired 70% of the outstanding stock of Nadir Corporation. The separate balance sheet of Apex immediately after the acquisition and the consolidated balance sheet are as follows:

	Apex	*Consolidated*
Current assets	$106,000	$146,000
Investment in Nadir (cost)	100,000	–
Goodwill	–	8,100
Fixed assets (net)	270,000	370,000
	$476,000	$524,100
Current liabilities	$ 15,000	$ 28,000
Capital stock	350,000	350,000
Minority interest	–	35,100
Retained earnings	111,000	111,000
	$476,000	$524,100

Ten-thousand dollars of the excess payment for the investment in Nadir was ascribed to undervaluation of its fixed assets; the balance of the excess payment was ascribed to goodwill. Current assets of Nadir included a $2,000 receivable from Apex which arose before they became related on an ownership basis.

The following two items relate to Nadir's separate balance sheet prepared at the time Apex acquired its 70% interest in Nadir.

10. What was the total of the current assets on Nadir's separate balance sheet at the time Apex acquired its 70% interest?
   a. $38,000.
   b. $40,000.
   c. $42,000.
   d. $104,000.

11. What was the total stockholders' equity on Nadir's separate balance sheet at the time Apex acquired its 70% interest?
   a. $64,900.
   b. $70,000.
   c. $100,000.
   d $117,000.

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12. Lock Corporation uses the allowance method of accounting for uncollectible accounts. During 1973, Lock had charges to doubtful accounts expense of $80,000 and wrote off accounts receivable of $55,000 as uncollectible. These transactions decreased working capital by
   a. $0.
   b. $25,000.
   c. $55,000.
   d. $80,000.

Items 13 and 14 are based on the following information:

Chart Corporation, which began business on January 1, 1972, appropriately uses the installment-sales method of reporting for accounting purposes. The following data were obtained for the years 1972 and 1973:

	1972	*1973*
Installment sales	$350,000	$420,000
Cost of installment sales	280,000	315,000
General and administrative expenses	35,000	42,000
Cash collections on installment sales of:		
1972	150,000	125,000
1973	–	200,000

13. What should the balance in the deferred-gross-profit control account be on December 31, 1973?
   a. $53,000.
   b. $70,000.
   c. $105,000.
   d. Chart **cannot** use the installment method because collections each year exceed 30% of sales.

14. A 1972 sale resulted in a default early in 1974. At the date of default, the balance of the installment receivable was $6,000, and the repossessed merchandise had a fair value of $4,100. Assuming the repossessed merchandise is to be recorded at fair value, the gain or loss on repossession should be
   a. $0.
   b. A $700 loss.
   c. A $4,100 gain.
   d. A $4,800 loss.

15. Harvest Corporation issued 200, 7% bonds for $200,000. Each $1,000 bond carried two detachable stock warrants. Each warrant grants an option to purchase one share of $85 par value common stock at $110 per share before June 30, 1975. At the date of the bond issue, Harvest's common stock was selling for $100 per share and the warrants were selling for $10 each. The credit for the warrants that Harvest should have recorded on the date of issue is
   a. $0.
   b. $2,000.
   c. $3,636.
   d. $4,000.

16. Lively Corporation's stockholders' equity section of its December 31, 1973, balance sheet was as follows:

Common stock authorized 1,200,000 shares; issued 800,000 shares; outstanding 700,000 shares; $5 par value	$ 4,000,000
Paid-in capital in excess of par	3,250,000
Retained earnings	5,240,000
	12,490,000
Less treasury stock, at cost, 100,000 shares	800,000
Total stockholders' equity	$11,690,000

During 1974, Lively reissues 50,000 shares of the treasury stock at $14 per share. No other similar transactions occur during 1974. What amount and type of gain should be reported on this transaction on the 1974 income statement?
   a. $0.
   b. $300,000 ordinary income.
   c. $300,000 extraordinary income.
   d. $250,000 ordinary income and $50,000 extraordinary income.

Number 2 (Estimated time — 50 to 60 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of managerial-accounting and quantitative-methods problems.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

17. The quantitative technique used to ascertain the average amount of change in one variable as it relates to incremental amounts of another variable is known as
   a. Monte-Carlo analysis.
   b. Simplex-method analysis.
   c. Markov analysis.
   d. Regression analysis.

18. A decision model designed to help its user find the **best** alternative or decision rule according to some criteria is said to be
   a. Bayesian.
   b. Probabilistic.
   c. Satisficing.
   d. Optimizing.

19. Given the basic equations for the maximization of profits in a linear programming model, what quantitative technique would generally be employed to arrive at an optimal solution?
    a. Regression analysis.
    b. Markov analysis.
    c. Monte-Carlo analysis.
    d. Simplex-method analysis.

20. The mathematical notation for the total cost function for a business is $4X^3 + 6X^2 + 2X + 10$ where X equals production volume. Which of the following is the mathematical notation for the average cost function for that business?
    a. $2(2X^2 + 3X + 2)$.
    b. $2X^3 + 3X^2 + X + 5$.
    c. $.4X^3 + .6X^2 + .2X + 1$.
    d. $4X^2 + 6X + 2 + \frac{10}{X}$.

Items 21 through 25 are based on the following information:

The following data relate to a year's budgeted activity for Patsy Corporation, a single product company:

	Units
Beginning inventory	30,000
Production	120,000
Available	150,000
Sales	110,000
Ending inventory	40,000

	Per Unit
Selling price	$5.00
Variable manufacturing costs	1.00
Variable selling costs	2.00
Fixed manufacturing costs (based on 100,000 units)	.25
Fixed selling costs (based on 100,000 units)	.65

Total fixed costs remain unchanged within the relevant range of 25,000 units to total capacity of 160,000 units.

21. The projected annual breakeven sales in units for Patsy Corporation is
    a. 30,000.
    b. 37,143.
    c. 45,000.
    d. 50,000.

22. The projected net income for Patsy Corporation for the year under direct (variable) costing is
    a. $110,000.
    b. $127,500.
    c. $130,000.
    d. $150,000.

23. If all the variances are charged to cost of goods sold, the projected net income for Patsy Corporation for the year under absorption costing is
    a. $122,500.
    b. $127,500.
    c. $130,000.
    d. $132,500.

24. A special order is received to purchase 10,000 units to be used in an unrelated market. Given the original data, what price per unit should be charged on this order to increase Patsy Corporation's net income by $5,000?
    a. $3.50.
    b. $4.40.
    c. $5.00.
    d. $6.50.

25. Concerning the data for Patsy Corporation, assume selling price increases by 20%; variable manufacturing costs increase by 10%; variable selling costs remain the same; and total fixed costs increase to $104,400. How many units must now be sold to generate a profit equal to 10% of the contribution margin?
    a. 36,000.
    b. 40,000.
    c. 43,320.
    d. 45,390.

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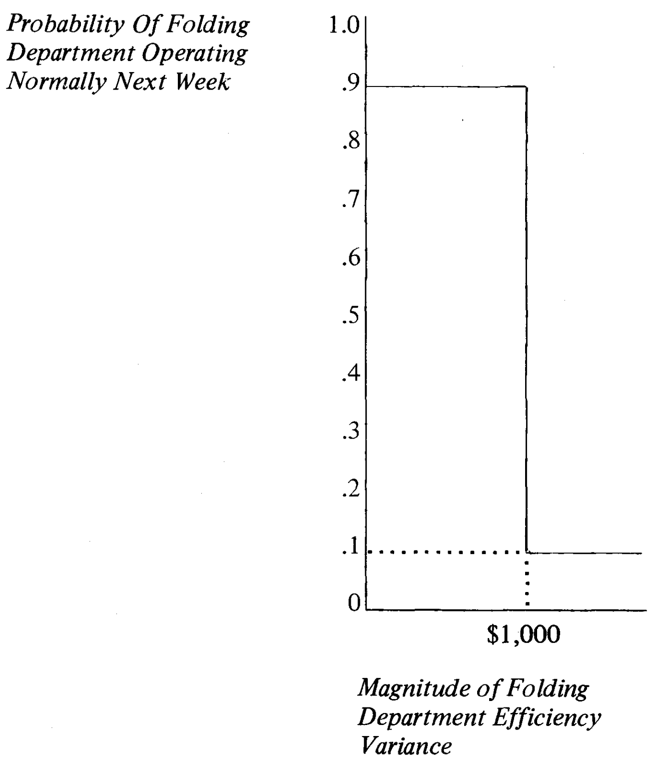
26. The Green Company's new process will be carried out in one department. The production process has an expected learning curve of 80%. The costs subject to the learning effect for the first batch produced by the process were $10,000. Using the simplest form of the learning function, the cumulative average cost per batch subject to the learning effect after the 16th batch has been produced may be estimated as
    a. $3,276.80.
    b. $4,096.00.
    c. $8,000.00.
    d. $10,000.00.

27. The learning function's mathematical form, enabling it to be plotted as a straight line on log-log graph paper, is
    a. Trigonometric.
    b. Cyclical.
    c. Linear.
    d. Exponential.

Items 28 through 31 are based on the following information:

The Folding-Department foreman must decide each week whether his department will operate normally the following week. He may order a corrective action if he feels the Folding Department will operate inefficiently; otherwise he does nothing. The foreman receives a weekly Folding-Department efficiency-variance report from the Accounting Department. A week in which the Folding Department operates inefficiently is usually preceded by a large efficiency variance. The graph below gives the probability that the Folding Department will operate normally in the following week as a function of the magnitude of the current week's variance reported to the foreman:



28. An efficiency variance of $1,500 this week means the probability of operating normally the following week is
    a. 0%.
    b. 10%.
    c. 90%.
    d. 100%.

29. What are the possible relationships between the current efficiency variance and next week's operations?
    a. Large variance followed by normal operation, large variance followed by inefficient operation, small variance followed by normal operation, and small variance followed by inefficient operation.
    b. Large variance followed by normal operation, small variance followed by inefficient operation, and small variance followed by normal operation.
    c. Large variance followed by inefficient operation, small variance followed by normal operation, and small variance followed by inefficient operation.
    d. Large variance followed by 90% of normal operation, small variance followed by 10% of normal operation, large variance followed by inefficient operation, and small variance followed by inefficient operation.

30. If the foreman can determine for certain whether the Folding Department will operate normally next week, and the cost of corrective action is less than the extra cost of operating the Folding Department inefficiently, then the best decision rule for the foreman to follow is
    a. If normal operations are predicted, do **not** take corrective action; if inefficient operations are predicted, take corrective action.
    b. Regardless of the current variance, do **not** take corrective action.
    c. If normal operations are predicted, take corrective action; if inefficient operations are predicted, do **not** take corrective action.
    d. Regardless of the current variance, take corrective action.

31. The following cost information is relevant to the Folding-Department foreman in deciding whether corrective action is warranted:

$500 = cost of corrective action which will assure normal operation of Folding Department for the following week.

$3,000 = excess cost of operating Folding Department inefficiently for one week.

The foreman receives a report that the Folding Department efficiency variance is $600. The expected cost of **not** taking corrective action is
    a. $0.
    b. $300.
    c. $2,700.
    d. $3,000.

Items 32 and 33 are based on the following information:

The Golden Hawk Manufacturing Company wants to maximize the profits on products A, B, and C. The contribution margin for each product follows:

Product	*Contribution Margin*
A	\$2
B	\$5
C	\$4

The production requirements and departmental capacities, by departments, are as follows:

Department	*Production Requirements By Product (Hours)*		
	A	B	C
Assembling	2	3	2
Painting	1	2	2
Finishing	2	3	1

Department	*Departmental Capacity (Total Hours)*
Assembling	30,000
Painting	38,000
Finishing	28,000

32. What is the profit-maximization formula for the Golden Hawk Company?
    a. $\$2A + \$5B + \$4C = X$ (where X = profit).
    b. $5A + 8B + 5C \leqslant 96{,}000$.
    c. $\$2A + \$5B + \$4C \leqslant X$ (where X = profit).
    d. $\$2A + \$5B + \$4C = 96{,}000$.

33. What is the constraint for the Painting Department of the Golden Hawk Company?
    a. $1A + 2B + 2C \geqslant 38{,}000$.
    b. $\$2A + \$5B + \$4C \geqslant 38{,}000$.
    c. $1A + 2B + 2C \leqslant 38{,}000$.
    d. $2A + 3B + 2C \leqslant 30{,}000$.

Number 3 (Estimated time –– 40 to 50 minutes)

Number 3 consists of two unrelated parts.

Part a. The controller of the Investor Corporation, a retail company, made three different schedules of gross margin for the first quarter ended September 30, 1974. These schedules appear below.

	Sales (\$10 per Unit)	*Cost of Goods Sold*	*Gross Margin*
Schedule A	\$280,000	\$118,550	\$161,450
Schedule B	280,000	116,900	163,100
Schedule C	280,000	115,750	164,250

The computation of cost of goods sold in each schedule is based on the following data:

	Units	*Cost per Unit*	*Total Cost*
Beginning inventory, July 1	10,000	\$4.00	\$40,000
Purchase, July 25	8,000	4.20	33,600
Purchase, August 15	5,000	4.13	20,650
Purchase, September 5	7,000	4.30	30,100
Purchase, September 25	12,000	4.25	51,000

The president of the corporation cannot understand how three different gross margins can be computed from the same set of data. As controller, you have explained to him that the three schedules are based on three different assumptions concerning the flow of inventory costs; i.e., first-in, first-out; last-in, first-out; and weighted average. Schedules A, B, and C were not necessarily prepared in this sequence of cost-flow assumptions.

Required:
Prepare three separate schedules computing cost of goods sold and supporting schedules showing the composition of the ending inventory under each of the three cost-flow assumptions.

Part b. The Grand Department Store, Inc., uses the retail-inventory method to estimate ending inventory for its monthly financial statements. The following data pertain to a single department for the month of October 1974.

Inventory, October 1, 1974:	
At cost	$ 20,000
At retail	30,000
Purchases (exclusive of freight and returns):	
At cost	100,151
At retail	146,495
Freight-in	5,100
Purchase returns:	
At cost	2,100
At retail	2,800
Additional markups	2,500
Markup cancellations	265
Markdowns (net)	800
Normal spoilage and breakage	4,500
Sales	135,730

Required:

1. Using the conventional retail method, prepare a schedule computing estimated lower-of-cost-or-market inventory for October 31, 1974.
2. A department store using the conventional retail-inventory method estimates the cost of its ending inventory as $29,000. An accurate physical count reveals only $22,000 of inventory at lower of cost or market.

List the factors that may have caused the difference between the computed inventory and the physical count.

Number 4 (Estimated time — 50 to 60 minutes)

Your tax client, George Brand, is single and operates an auto supply and service business as a sole proprietorship. The business is on the accrual basis for tax purposes. You have obtained the following information relative to Brand's 1973 transactions to aid in calculating his adjusted gross income for 1973:

- Selected amounts from the December 31, 1972, balance sheet and corresponding amounts for December 31, 1973 (properly reflecting all 1973 transactions) are as follows:

	December 31, 1972 *Debit (Credit)*	*December 31, 1973* *Debit (Credit)*
Accounts receivable	$ 43,000	$ 40,300
Inventory (per physical count)	72,000	76,000
Machinery and equipment, tax basis	285,000	292,500
Accumulated depreciation, tax basis	(120,000)	(125,500)
Accounts payable (merchandise purchases only)	(32,500)	(31,700)

- From Mr. Brand's bank statements and checkbook you prepared the following summary of cash receipts and disbursements for 1973:

Cash Receipts

Collections on sales	$422,500
Interest – State of Florida bonds	2,400
Proceeds from sale of milling machine	42,000
Proceeds from insurance claim	27,500
Proceeds from sale of stock	11,500
Dividends from U.S. domestic corporation	400
Total cash receipts	$506,300

Cash Disbursements

Purchases of merchandise	$281,300
Charitable contributions	2,250
Interest payments on business loan	1,400
Principal payments on business loan	17,650
Purchase of business machinery and equipment	79,300
Purchase of stock	15,550
Payment of 1972 federal income tax	2,650
Payment of estimated 1973 federal income tax	15,700
Other business expenses	64,000
Other personal expenses	25,000
Total cash disbursements	$504,800

The following additional information pertains to various items in the cash receipts and disbursements summary:

- The milling machine sold for $42,000 had been held five years and depreciated on a straight-line basis. Accumulated depreciation from the date acquired through the date of sale was $15,000.
- The insurance proceeds of $27,500 relate to a machine that was destroyed by fire during 1973. This machine had an original cost of $33,000 and a book value of $23,000 when destroyed. Mr. Brand immediately replaced the machine with a similar one costing $32,300 and elected to apply the special tax provisions relating to involuntary conversions.
- In addition to the above purchase of a machine, other equipment was purchased in 1973 for $47,000.
- Proceeds from the sale of stock were $11,500 on November 12, 1973. The stock had been purchased by Brand for $15,550 on August 10, 1973.
- Brand had a long-term capital loss carryover of $5,950 from transactions in 1972 (prior year).

Required:

Compute Mr. Brand's 1973 adjusted gross income. Any possible alternative treatment should be resolved in a manner that will minimize adjusted gross income. Show supporting schedules in good form.

Number 5 (Estimated time — 40 to 50 minutes)

Blue Corporation was merged into Ace Corporation on August 31, 1974, with Blue Corporation going out of existence. Both corporations had fiscal years ending on August 31 and Ace Corporation will retain this fiscal year. The enclosed worksheet contains a balance sheet for each corporation and a combined balance sheet as of August 31, 1974, immediately prior to the merger and net income figures for each corporation for the fiscal year ended August 31, 1974. You have obtained the following additional information as of the date of the merger:

- The fair value of the assets and liabilities on August 31, 1974, of Ace Corporation and Blue Corporation was as follows:

	Ace	*Blue*
Current assets	$ 4,950,000	$ 3,400,000
Plant and equipment (net)	22,000,000	14,000,000
Patents	570,000	360,000
Market research	150,000	40,000
Total assets	27,670,000	17,800,000
Liabilities	(2,650,000)	(2,100,000)
Net assets	$25,020,000	$15,700,000

- Ace Corporation capitalized its fiscal year 1974 market-research costs and has always amortized them over five years beginning with the year of expenditure. All market-research costs of Ace have been appropriately capitalized and amortized for the current and preceding years. Blue Corporation incurred $50,000 of market-research costs which were expensed during the fiscal year ending August 31, 1974. Blue did **not** have any market-research costs in any year before 1974. Blue will adopt Ace's method of accounting for market-research costs.
- Internally generated general expenses incurred because of the merger were $25,000 and are included in the current assets of Ace as a prepaid expense.
- There were no intercompany transactions during the year.
- Before the merger, Ace had 3,000,000 shares of common stock authorized; 1,200,000 shares issued; and 1,100,000 shares outstanding. Blue had 750,000 shares of common stock authorized, issued, and outstanding.

Required:

On the worksheet on page 73, prepare the balance sheet and determine the amount of net income under **each** of the following dependent situations. Include explanations of adjustments on the worksheet. Cross-reference the explanations to the adjustments. **Do not prepare formal journal entries.**

a. Ace Corporation exchanged 400,000 shares of previously unissued common stock and 100,000 shares of treasury stock for all the outstanding common stock of Blue Corporation. All the conditions for pooling-of-interests accounting enumerated in APB Opinion No. 16 ("Business Combinations") were met.

b. Ace Corporation purchased the assets and assumed the liabilities of Blue Corporation by paying $3,100,000 cash and issuing debentures of $16,900,000 at face value.

Ace Corporation and Blue Corporation
WORKSHEET FOR POOLING OF INTERESTS AND PURCHASE ACCOUNTING
August 31, 1974
(Required for Number 5)

	Ace Corporation	*Blue Corporation*	*Combined*	a. *Adjustments Debit*	a. *Adjustments Credit*	*Pooling of Interests*	b. *Adjustments Debit*	b. *Adjustments Credit*	*Purchase*
Current assets	$ 4,350,000	$ 3,000,000	$ 7,350,000						
Plant and equipment (net)	18,500,000	11,300,000	29,800,000						
Patents	450,000	200,000	650,000						
Market research	150,000	—	150,0000						
	$23,450,000	$14,500,000	$37,950,000						
Liabilities	$ 2,650,000	$ 2,100,000	$ 4,750,000						
Common stock $10 par value	12,000,000	—	12,000,000						
Common stock $5 par value	—	3,750,000	3,750,000						
Paid-in capital in excess of par	4,200,000	—	4,200,000						
Paid-in capital in excess of par	—	3,200,000	3,200,000						
Retained earnings	5,850,000	—	5,850,000						
Retained earnings	—	5,450,000	5,450,000						
	24,700,000	14,500,000	39,200,000						
Less treasury stock, at cost, 100,000 shares	1,250,000	—	1,250,000						
	$23,450,000	$14,500,000	$37,950,000						
Net income (no extraordinary items) for fiscal year ended August 31, 1974	$ 2,450,000	$ 1,300,000							

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN AUDITING

November 7, 1974; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	35	40
No. 2	35	40
No. 3	20	25
No. 4	20	25
No. 5	20	25
No. 6	20	30
No. 7	20	25
Total for examination	170	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 35 to 40 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

96. One of the generally accepted auditing standards specifies that the auditor
   a. Inspect all fixed assets acquired during the year.
   b. Charge fair fees based on cost.
   c. Make a proper study and evaluation of the existing internal control.
   d. May not solicit clients.

Answer Sheet

96. a. :::::::::: b. :::::::::: c. ▬▬▬ d. ::::::::::

Items to be Answered

1. McPherson Corp. does **not** make an annual physical count of year-end inventories, but instead makes test counts on the basis of a statistical plan. During the year Mullins, CPA, observes such counts as he deems necessary and is able to satisfy himself as to the reliability of the client's procedures. In reporting on the results of his examination Mullins
   a. Can issue an unqualified opinion without disclosing that he did not observe year-end inventories.
   b. Must comment in the scope paragraph as to his inability to observe year-end inventories, but can nevertheless issue an unqualified opinion.
   c. Is required, if the inventories were material, to disclaim an opinion on the financial statements taken as a whole.
   d. Must, if the inventories were material, qualify his opinion.

2. According to Statement on Auditing Standards No. 1, the auditor's responsibility for failure to detect fraud arises
   a. When such failure clearly results from failure to comply with generally accepted auditing standards.
   b. Whenever the amounts involved are material.
   c. Only when the examination was specifically designed to detect fraud.
   d. Only when such failure clearly results from negligence so gross as to sustain an inference of fraud on the part of the auditor.

3. On June 15, 1973, Ward, CPA, accepted an engagement to perform an audit of the Grant Co. for the year ended December 31, 1973. Grant Co. has **not** previously been audited by a CPA and Ward has been unable to satisfy himself with respect to opening inventories. How should Ward report on his examination?
   a. He would have to disclaim an opinion or qualify his opinion on the December 31, 1973, balance sheet, but could issue an unqualified opinion on the income statement and the statement of changes in financial position.
   b. He must disclaim an opinion on the financial statements taken as a whole.
   c. He could give an unqualified opinion on the financial statements taken as a whole so long as the change in the inventories from the beginning of the year to the end of the year was not material.
   d. He would have to disclaim an opinion or qualify his opinion on the income statement and the statement of changes in financial position, but could issue an unqualified opinion on the December 31, 1973, balance sheet.

4. On January 2, 1974, the Retail Auto Parts Co. received a notice from its primary suppliers that effective immediately all wholesale prices would be increased ten percent. On the basis of the notice, Retail Auto Parts Co. revalued its December 31, 1973, inventory to reflect the higher costs. The inventory constituted a material proportion of total assets; however, the effect of the revaluation was material to current assets but **not** to total assets or net income. In reporting on the company's financial statements for the year ended December 31, 1973, in which inventory is valued at the adjusted amounts, the auditor should
   a. Issue an unqualified opinion provided the nature of the adjustment, and the amounts involved are disclosed in footnotes.
   b. Issue a qualified opinion.
   c. Disclaim an opinion.
   d. Issue an adverse opinion.

5. As a consequence of his failure to adhere to generally accepted auditing standards in the course of his examination of the Lamp Corp., Harrison, CPA, did **not** detect the embezzlement of a material amount of funds by the company's controller. As a matter of common law, to what extent would Harrison be liable to the Lamp Corp. for losses attributable to the theft?
   a. He would have no liability, since the ordinary examination cannot be relied upon to detect defalcations.
   b. He would have no liability because privity of contract is lacking.
   c. He would be liable for losses attributable to his negligence.
   d. He would be liable only if it could be proven that he was grossly negligent.

Items 6 through 9 are based on the following information:

The Mastermind Security Company has asked you to prepare a report on its internal control. The report is to be based on your study and evaluation of the company's control system made in conjunction with your recently completed annual audit of Mastermind. Mastermind is considering the inclusion of the report on internal control in a document that will be sent to stockholders. Mastermind's stock is widely held and actively traded.

6. Under which of the following conditions would the inclusion of the internal-control report in a document to stockholders be prohibited?
   a. If the document contains only the internal-control report and unaudited interim financial statements.
   b. If only a select class of stockholders receives the document.
   c. If Mastermind has requested the internal-control report because of a ruling by a regulatory agency.
   d. If the internal-control report indicates management negligence.

7. If the report on internal control is distributed to the general public it must contain specific language describing several matters. Which of the following must be included in the specific language?
   a. The distinction between internal administrative controls and internal accounting controls.
   b. The various tests and procedures utilized by the auditor during his review of internal control.
   c. The objective of internal accounting controls.
   d. The reason(s) Mastermind's management requested a report on internal control.

8. If the report on internal control will be distributed to Mastermind's stockholders, the opening paragraph of the internal-control report should indicate its timeliness by including which of the following pair of dates?
   a. The date on which your review of internal control was completed and the date on which you agreed to prepare the internal-control report.
   b. The date of the audit report issued on Mastermind's financial statements and the date on which you agreed to prepare the internal-control report.
   c. The date of Mastermind's financial statements and the date on which your review of internal control was completed.
   d. The date of Mastermind's financial statements and the date of the audit report issued on those financial statements.

9. How should the report on internal control deal with the possibility that some stockholders might use the internal-control report for speculation about future adequacy of Mastermind's internal-control system?
   a. The report should contain an opinion as to whether the present internal-control system can be relied upon for the next accounting period.
   b. The report should make no mention of the possibility of making such projections.
   c. The report should disclose management's opinion about the number of future accounting periods during which the present internal-control system can be relied upon.
   d. The report should discuss the risk involved in making such projections.

10. What is the independent auditor's responsibility prior to completion of field work when he believes that a material fraud may have occurred?
    a. Notify the appropriate law enforcement authority.
    b. Investigate the persons involved, the nature of the fraud, and the amounts involved.
    c. Reach an understanding with the appropriate client representatives as to the desired nature and extent of subsequent audit work.
    d. Continue to perform normal audit procedures and write the audit report in such a way as to disclose adequately the suspicions of material fraud.

11. What is the independent auditor's principal purpose for conducting a study and evaluation of the existing system of internal control?
    a. To comply with generally accepted accounting principles.
    b. To obtain a measure of assurance of management's efficiency.
    c. To maintain a state of independence in mental attitude in all matters relating to the audit.
    d. To determine the nature, timing, and extent of subsequent audit work.

12. The actual operation of an internal-control system may be most objectively evaluated by
    a. Completing a questionnaire and flowchart related to the accounting system in the year under audit.
    b. Review of the previous year's audit workpapers to update the report of internal-control evaluation.
    c. Selection of items processed by the system and determination of the presence or absence of errors and compliance deviations.
    d. Substantive tests of account balances based on the auditor's assessment of internal-control strength.

13. Which of the following criteria is unique to the auditor's attest function?
   a. General competence.
   b. Familiarity with the particular industry of which his client is a part.
   c. Due professional care.
   d. Independence.

14. On January 15, 1974, before the Longview Co. **released** its financial statements for the year ended December 31, 1973, Agie Corp., a customer, declared bankruptcy. Agie has had a history of financial difficulty. Longview estimates that it will suffer a material loss on an account receivable from Agie. How should this loss be disclosed or recognized?
   a. The loss should be disclosed in footnotes to the financial statements, but the financial statements themselves need not be adjusted.
   b. The loss should be disclosed in an explanatory paragraph in the auditor's report.
   c. No disclosure or recognition is required.
   d. The financial statements should be adjusted to recognize the loss.

15. During 1973 the research staff of Scientific Research Corp. devoted its entire efforts toward developing a new pollution-control device. All costs which could be attributed directly to the pollution-control-device project were accounted for as deferred charges and classified on the balance sheet at December 31, 1973, as a current asset. In the course of its audit of the corporation's 1973 financial statements, Anthony, CPA, found persuasive evidence that the research conducted to date would **not** result in a marketable product. Assuming that the deferred research charges are significantly material in relationship to both income and total assets, Anthony should
   a. Issue a "subject to" qualified opinion.
   b. Disclaim an opinion.
   c. Issue an adverse opinion.
   d. Give an unqualified opinion provided that the uncertainty of ultimate realization of the deferred charges is disclosed in the footnotes.

16. What is the general character of the three generally accepted auditing standards classified as general standards?
   a. Criteria for competence, independence, and professional care of individuals performing the audit.
   b. Criteria for the content of the financial statements and related footnote disclosures.
   c. Criteria for the content of the auditor's report on financial statements and related footnote disclosures.
   d. The requirements for the planning of the audit and supervision of assistants, if any.

17. A client's management has asked you to consider a special study of a proposed modification of the system of internal control. It wishes to modify the existing system in approximately eighteen months in conjunction with an upgrading of its computer system.

The scope of the study and evaluation to be reported on would be substantially more extensive than that required by a normal financial audit. The special report would be used solely for the internal information of management. Which of the following is the most appropriate response concerning the acceptance or rejection of the proposed engagement?
   a. Explain that you are prohibited from accepting such an engagement because the client is not planning to allow distribution of the report to the general public upon request.
   b. Explain that you can accept the engagement if it will not require decisions on your part which would impair your independence in connection with future audits of the client.
   c. Explain that you are prohibited from accepting such an engagement because it would deal with a proposed rather than an existing system of controls.
   d. Explain that you can accept the engagement but that there is a standard reporting format which you will be required to use when communicating your findings.

18. Pickens and Perkins, CPAs, decide to incorporate their practice of accountancy. According to the AICPA Code of Professional Ethics, shares in the corporation can be issued
   a. Only to persons qualified to practice as CPAs.
   b. Only to employees and officers of the firm.
   c. Only to persons qualified to practice as CPAs and members of their immediate families.
   d. To the general public.

19. Fenn & Co., CPAs, has time available on a computer which it uses primarily for its own internal record-keeping. Aware that the computer facilities of Delta Equipment Co., one of Fenn's audit clients, are inadequate for the company needs, Fenn offers to maintain on its computer certain routine accounting records for Delta. If Delta were to accept the offer and Fenn were to continue to function as independent auditor for Delta, then Fenn would be in violation of
   a. SEC, but not AICPA, provisions pertaining to auditors' independence.
   b. Both SEC and AICPA provisions pertaining to the auditors' independence.
   c. AICPA, but not SEC, provisions pertaining to auditors' independence.
   d. Neither AICPA nor SEC provisions pertaining to auditors' independence.

20. Your independent examination of the Dey Co. reveals that the firm's poor financial condition makes it unlikely that it will survive as a going concern. Assuming that the financial statements have otherwise been prepared in accordance with generally accepted accounting principles, what disclosure should you make of the company's precarious financial position?
   a. You should issue an unqualified opinion, but in a paragraph between the scope and opinion paragraphs of your report direct the reader's attention to the poor financial condition of the company.
   b. You should insist that a note to the financial statements clearly indicate that the company appears to be on the verge of bankruptcy.
   c. You need not insist on any particular disclosure, since the company's poor financial condition is clearly indicated by the financial statements themselves.
   d. You should provide adequate disclosure and appropriately modify your opinion because the company does not appear to be a going concern.

21. Davis, a CPA in public practice, contacts Henderson, an employee of Rose Co., and makes him an offer of employment without first notifying Rose. According to the AICPA Code of Professional Ethics such a practice
   a. Is a violation only if Henderson is a CPA.
   b. Is a violation regardless of whether Henderson is a CPA or Rose is a CPA firm.
   c. Is a violation if Rose is a CPA firm.
   d. Is not a violation if Rose is a CPA firm.

22. Warner, CPA, places a 2" by 2" display advertisement in a national financial newspaper. The advertisement reads: "Wanted: Outgoing CPA with partnership potential. Must have 5 years experience in tax department of a CPA firm. Reply Box 1940." Under the AICPA Code of Professional Ethics such an advertisement would
   a. Violate the provisions dealing with advertising.
   b. Violate the provisions dealing with specialization.
   c. Violate the provisions dealing with encroachment.
   d. Not be a violation.

23. Evidential matter is generally considered competent when
   a. It has the qualities of being relevant, objective, and free from known bias.
   b. There is enough of it to afford a reasonable basis for an opinion on financial statements.
   c. It has been obtained by random selection.
   d. It consists of written statements made by managers of the enterprise under audit.

24. Jackson, CPA, is the principal auditor for the Jones Corp. He requests another CPA to perform the examination of a subsidiary corporation which is located in a distant state. Jackson has satisfied himself as to the independence, professional reputation, and conduct of the examination of the other auditor. What reference, if any, must Jackson make to the work of the other CPA assuming that he is willing to accept responsibility for his work?
   a. He should indicate the extent of the other auditor's work in the scope paragraph of his report and state in the opinion paragraph he accepts full responsibility for the work.
   b. He need not make any reference to the examination or report of the other CPA.
   c. He should make certain that the report of the other CPA accompanies his own.
   d. He should indicate the extent of the other auditor's work in the scope paragraph of his report, but he need not make any reference to it in the opinion paragraph.

25. An auditor should avoid expressions of negative assurance except in
   a. Internal-control letters.
   b. Letters to underwriters.
   c. Piecemeal opinions.
   d. Reports containing an adverse opinion.

Number 2 (Estimated time — 35 to 40 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

26. In which one of the following situations is a CPA required to sign a federal tax return?
   a. The CPA types a return from a draft submitted by his client.
   b. The CPA prepares a return for a local civic organization for no fee.
   c. The CPA prepares a capital-gains schedule and sends it to his client for inclusion in the tax return the client is preparing.
   d. The CPA reviews the client-prepared tax return before it is filed to determine the adequacy of the provision for income taxes in his audit of the client's financial statements.

27. What action should be taken by Washington, CPA, when he discovers that Mr. Madison refuses to answer certain questions on his federal income tax return because a truthful answer would probably prompt an IRS audit of the return?
   a. He should sign the preparer's declaration on the tax return.
   b. He should himself write the answers on the tax return and then sign the preparer's declaration.
   c. He should sign the preparer's declaration on the tax return and attach a statement that he is not responsible for the questions on the tax return.
   d. He should refuse to sign the preparer's declaration on a tax return that is incomplete as to questions for which answers are available.

28. The certified public accounting firm of Lincoln, Johnson, & Grant is the auditor for the Union Corporation. Mr. Lee, President of Union Corp., has asked the firm to perform management advisory services in the area of inventory management. Mr. Lee believes the procedures in this area are inefficient. Considering the dual engagement of the regular audit and the management services assignment, which of the following functions could impair the CPA firm's independence?
   a. Identify the inventory-management problem as caused by the procedures presently operative in the purchasing, receiving, storage, and issuance operations.
   b. Study and evaluate the inventory-management problem and suggest several alternative solutions.
   c. Develop a time schedule for implementation of the solution adopted by Mr. Lee, to be carried out and supervised by Union Corp. personnel.
   d. Supervise management of purchasing, receiving, storage, and issuance operations.

29. Marquis, CPA, occasionally undertakes management-advisory-services engagements, although his practice deals primarily with auditing services. The Keller Corporation has recently asked Marquis to make a study of the company's executive-compensation package. Marquis has no prior experience in this area. What would be the most appropriate course of action for Marquis to follow?
   a. Decline the engagement because he cannot expect to complete it without undertaking research in the area.
   b. Accept the engagement and issue a report which may lead to the belief that he vouches for the achievability of the results indicated by the recommended actions.
   c. Accept the engagement and research, study, or consult with knowledgeable experts in order to increase his competence.
   d. Accept the engagement and perform it in accordance with generally accepted auditing standards.

Items 30 through 34 are based on the following information:

An audit partner is developing an office training program to familiarize his professional staff with statistical decision models applicable to the audit of dollar-value balances. He wishes to demonstrate the relationship of sample sizes to population size and variability and the auditor's specifications as to precision and confidence level. The partner prepared the following table to show comparative population characteristics and audit specifications of two populations.

	Characteristics of Population 1 Relative to Population 2		*Audit Specifications as to a Sample from Population 1 Relative to a Sample from Population 2*	
	Size	*Variability*	*Specified Precision*	*Specified Confidence Level*
Case 1	Equal	Equal	Equal	Higher
Case 2	Equal	Larger	Wider	Equal
Case 3	Larger	Equal	Tighter	Lower
Case 4	Smaller	Smaller	Equal	Lower
Case 5	Larger	Equal	Equal	Higher

In each item 30 through 34 you are to indicate for the specified case from the above table the required sample size to be selected from population 1 relative to the sample from population 2. **Your answer choice should be selected from the following responses:**
   a. Larger than the required sample size from population 2.
   b. Equal to the required sample size from population 2.
   c. Smaller than the required sample size from population 2.
   d. Indeterminate relative to the required sample size from population 2.

30. In case 1 the required sample size from population 1 is

31. In case 2 the required sample size from population 1 is

32. In case 3 the required sample size from population 1 is

33. In case 4 the required sample size from population 1 is

34. In case 5 the required sample size from population 1 is

Items 35 through 38 are based on the following information:

The following sales procedures were encountered during the regular annual audit of Marvel Wholesale Distributing Company.

Customer orders are received by the sales-order department. A clerk computes the dollar amount of the order and sends it to the credit department for approval. Credit approval is stamped on the order and returned to the sales-order department. An invoice is prepared in two copies and the order is filed in the "customer order" file.

The "customer copy" of the invoice is sent to the billing department and held in the "pending" file awaiting notification that the order was shipped.

The "shipping copy" of the invoice is routed through the warehouse and the shipping department as authority for the respective departments to release and ship the merchandise. Shipping-department personnel pack the order and prepare a three-copy bill of lading: the original copy is mailed to the customer, the second copy is sent with the shipment, and the other is filed in sequence in the "bill of lading" file. The invoice "shipping copy" is sent to the billing department.

The billing clerk matches the received "shipping copy" with the customer copy from the "pending" file. Both copies of the invoice are priced, extended, and footed. The customer copy is then mailed directly to the customer, and the "shipping copy" is sent to the accounts-receivable clerk.

The accounts-receivable clerk enters the invoice data in a sales-accounts-receivable journal, posts the customer's account in the "subsidiary customer's accounts ledger," and files the "shipping copy" in the "sales invoice" file. The invoices are numbered and filed in sequence.

35. In order to gather audit evidence concerning the proper credit approval of sales, the auditor would select a sample of transaction documents from the population represented by the
   a. "Customer order" file.
   b. "Bill of lading" file.
   c. "Subsidiary customers' accounts ledger."
   d. "Sales invoice" file.

36. In order to determine whether the system of internal control operated effectively to minimize errors of failure to post invoices to customers' accounts ledger, the auditor would select a sample of transactions from the population represented by the
   a. "Customer order" file.
   b. "Bill of lading" file.
   c. "Subsidiary customers' accounts ledger."
   d. "Sales invoice" file.

37. In order to determine whether the system of internal control operated effectively to minimize errors of failure to invoice a shipment, the auditor would select a sample of transactions from the population represented by the
   a. "Customer order" file.
   b. "Bill of lading" file.
   c. "Subsidiary customers' accounts ledger."
   d. "Sales invoice" file.

38. In order to gather audit evidence that uncollected items in customers' accounts represented valid trade receivables, the auditor would select a sample of items from the population represented by the
   a. "Customer order" file.
   b. "Bill of lading" file.
   c. "Subsidiary customers' accounts ledger."
   d. "Sales invoice" file.

39. The estimated error rate obtained from attribute sampling is most useful in satisfying the auditing standard which states
   a. The work is to be adequately planned and assistants, if any, are to be properly supervised.
   b. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion.
   c. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
   d. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

40. The auditor's failure to recognize an error in an amount or an error in an internal-control data-processing procedure is described as a
   a. Statistical error.
   b. Sampling error.
   c. Standard error of the mean.
   d. Nonsampling error.

41. The accounts of a not-for-profit organization such as a hospital may include several object classification codes. Such codes usually denote which of the following accounting classifications?
   a. Expenses.
   b. Assets.
   c. Liabilities.
   d. Revenues.

42. The use of external labels in conjunction with magnetic tape storage is most likely to prevent errors that might be made by which of the following?
    a. A computer programmer.
    b. A systems analyst.
    c. A keypunch operator.
    d. A computer operator.

43. Rosenberg, CPA, is auditing Bulmash Hospital, a private not-for-profit organization. What is Rosenberg's best source of evidence to substantiate the classification of restricted funds?
    a. Minutes of the board of directors.
    b. Correspondence from executors or donors.
    c. State laws and regulations.
    d. Confirmation with trust company.

Items 44 and 45 apply to a CPA's examination of the financial statements of the Echo Corporation for the year ended December 31, 1973. An auditing procedure is described in each item and four potential errors or questionable practices are listed as answer choices. You are to choose the error or questionable practice that has the best chance of being detected by the **specific** auditing procedure given.

44. The CPA analyzes the accrued-interest-payable account for the year, recomputes the amounts of payments and beginning and ending balances and reconciles to the interest-expense account.
    a. Interest revenue of $80 on a note receivable was credited against miscellaneous expense.
    b. A provision of Echo's loan agreement was violated. Dividends on common stock are prohibited if income available for interest and dividends is not three times interest requirements.
    c. Interest paid on an open account was charged to the raw-material purchases account.
    d. A note payable had not been recorded. Interest of $150 on the note was properly paid and charged to the interest-expense account.

45. The CPA compares 1973 revenues and expenses with the prior year and investigates all changes exceeding 10%.
    a. The cashier began lapping accounts receivable in 1973.
    b. Because of worsening economic conditions, the 1973 provision for uncollectible accounts was inadequate.
    c. Echo changed its capitalization policy for small tools in 1973.
    d. An increase in property tax rates has not been recognized in Echo's 1973 accrual.

Items 46 and 47 are based on the following information:

A sales transaction card was designed to contain the following information:

Card Column	*Information*
1-10	Customer account number
11-30	Customer name
31-38	Amount of sale
39-44	Sales date
45-46	Store code number
47-49	Sales clerk number
50-59	Invoice number

46. If such a card is rejected during computer processing because the sales clerk whose identification number appears on the record does **not** work at the store indicated by the numbers in card columns 45 & 46, then the error was probably detected by which of the following?
    a. A self-checking number.
    b. A combination check.
    c. A valid-character check.
    d. A limit check.

47. If the last letter of a customer's name is erroneously entered in card column 31, which of the following is most likely to detect the error during an input edit run?
    a. A logic check.
    b. A combination check.
    c. A valid-character check.
    d. A self-checking number.

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48. When a CPA expresses an opinion on financial statements, his responsibilities extend to
    a. The underlying wisdom of his client's management decisions.
    b. Whether the results of his client's operating decisions are fairly presented in the financial statements.
    c. Active participation in the implementation of the advice given to his client.
    d. An ongoing responsibility for his client's solvency.

49. Under the AICPA Code of Professional Ethics, the CPA is allowed to
    a. Include the wording "Income Tax Returns Prepared" on the door of his office.
    b. Include the word "consultant" on his business card.
    c. Use his CPA title when engaged in sales promotion.
    d. Imprint his firm's name on newsletters not prepared by his firm.

50. Under the AICPA Code of Professional Ethics, a practicing CPA is allowed to
   a. Send announcements of a seminar to nonclients.
   b. Solicit the opportunity to appear on a program sponsored by others.
   c. Inform other practitioners in letter form or by personal contact of his availability to provide them or their clients with professional services.
   d. Pay a commission to an attorney to obtain a client.

Number 3 (Estimated time — 20 to 25 minutes)

David Anderson, CPA, is engaged in the examination of the financial statements of Redondo Manufacturing Corporation for the year ended June 30, 1974. Redondo's inventories at year end include finished merchandise on consignment with consignees, and finished merchandise held in public warehouses. The merchandise held in public warehouses is pledged as collateral for outstanding debt.

Required:

Normal inventory and notes-payable auditing procedures have been satisfactorily completed. Describe the specific additional auditing procedures that Anderson should undertake with respect to:

a. Consignments out.

b. Finished merchandise in public warehouses pledged as collateral for outstanding debt.

Number 4 (Estimated time — 20 to 25 minutes)

In connection with his examination of Flowmeter, Inc., for the year ended December 31, 1973, Hirsch, CPA, is aware that certain events and transactions that took place after December 31, 1973, but before he issues his report dated February 28, 1974, may affect the company's financial statements.

The following material events or transactions have come to his attention.

1. On January 3, 1974, Flowmeter, Inc., received a shipment of raw materials from Canada. The materials had been ordered in October 1973 and shipped FOB shipping point in November 1973.

2. On January 15, 1974, the company settled and paid a personal injury claim of a former employee as the result of an accident which occurred in March 1973. The company had not previously recorded a liability for the claim.

3. On January 25, 1974, the company agreed to purchase for cash the outstanding stock of Porter Electrical Co. The acquisition is likely to double the sales volume of Flowmeter, Inc.

4. On February 1, 1974, a plant owned by Flowmeter, Inc., was damaged by a flood resulting in an uninsured loss of inventory.

5. On February 5, 1974, Flowmeter, Inc., issued and sold to the general public $2,000,000 in convertible bonds.

Required:

For each of the above events or transactions, indicate the audit procedures that should have brought the item to the attention of the auditor, and the form of disclosure in the financial statements including the reasons for such disclosures.

Arrange your answer in the following format.

Item No.	*Audit Procedures*	*Required Disclosure and Reasons*

Number 5 (Estimated time — 20 to 25 minutes)

Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor. In the course of an independent audit of financial statements, the auditor will perform detail tests of samples of transactions from various large-volume populations. The auditor may also audit various types of transactions by tracing a single transaction of each type through all stages of the accounting system.

Required:

a. What are the various audit objectives associated with a sample of transactions from a large-volume population?

b. What evidential matter would the auditor expect to gain from auditing various types of transactions by tracing a single transaction of each type through all stages of the accounting system?

Number 6 (Estimated time –– 20 to 30 minutes)

The limitations on the CPA's professional responsibilities when he is associated with unaudited financial statements are often misunderstood. These misunderstandings can be substantially reduced by carefully following professional pronouncements in the course of his work, and taking other appropriate measures.

Required:

The following list describes seven situations the CPA may encounter, or contentions he may have to deal with in his association with and preparation of **unaudited** financial statements. Briefly discuss the extent of the CPA's responsibilities and, if appropriate, the actions he should take to minimize any misunderstandings. **Number your answers to correspond with the numbering in the following list.**

1. The CPA was engaged by telephone to perform write-up work including the preparation of financial statements. His client believes that the CPA has been engaged to audit the financial statements and examine the records accordingly.

2. A group of businessmen who own a farm which is managed by an independent agent engage a CPA to prepare quarterly unaudited financial statements for them. The CPA prepares the financial statements from information given to him by the independent agent. Subsequently, the businessmen find the statements were inaccurate because their independent agent was embezzling funds. The businessmen refuse to pay the CPA's fee and blame him for allowing the situation to go undetected contending that he should not have relied on representations from the independent agent.

3. In comparing the trial balance with the general ledger the CPA finds an account labeled "audit fees" in which the client has accumulated the CPA's quarterly billings for accounting services including the preparation of quarterly unaudited financial statements.

4. Unaudited financial statements were accompanied by the following letter of transmittal from the CPA.

> "We are enclosing your company's balance sheet as of June 30, 1974, and the related statements of income and retained earnings and changes in financial position for the six months then ended which we have reviewed."

5. To determine appropriate account classification, the CPA reviewed a number of the client's invoices. He noted in his working papers that some invoices were missing but did nothing further because he felt they did not affect the unaudited financial statements he was preparing. When the client subsequently discovered that invoices were missing he contended that the CPA should not have ignored the missing invoices when preparing the financial statements and had a responsibility to at least inform him that they were missing.

6. The CPA has prepared a draft of unaudited financial statements from the client's records. While reviewing this draft with his client, the CPA learns that the land and building were recorded at appraisal value.

7. The CPA is engaged to review without audit the financial statements prepared by the client's controller. During this review, the CPA learns of several items which by generally accepted accounting principles would require adjustments of the statements and footnote disclosure. The controller agrees to make the recommended adjustments to the statements but says that he is not going to add the footnotes because the statements are unaudited.

Number 7 (Estimated time -- 20 to 25 minutes)

You are reviewing audit work papers containing a narrative description of the Tenney Corporation's factory payroll system. A portion of that narrative is as follows:

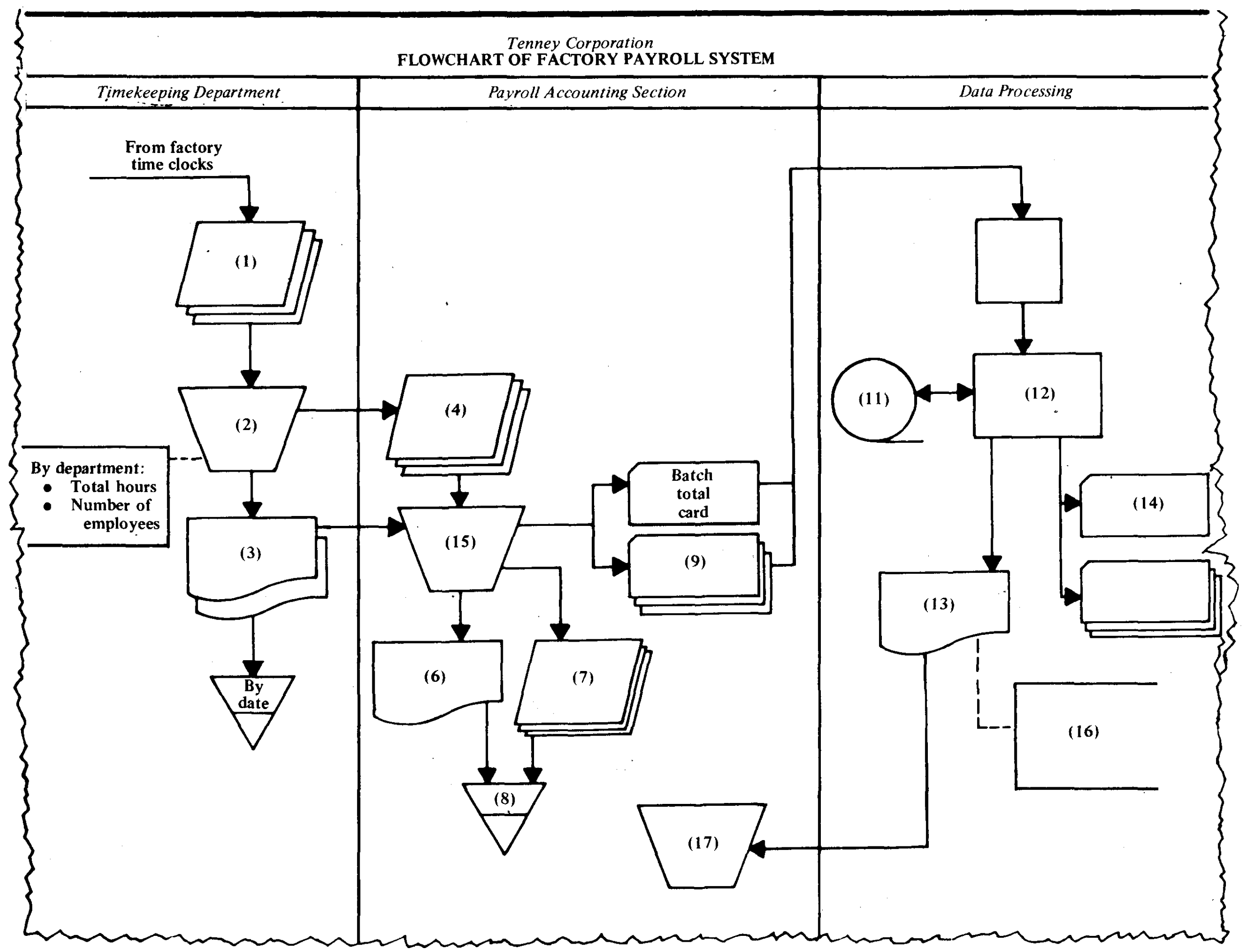
> Factory employees punch time clock cards each day when entering or leaving the shop. At the end of each week the timekeeping department collects the time cards and prepares duplicate batch-control slips by department showing total hours and number of employees. The time cards and original batch-control slips are sent to the payroll accounting section. The second copies of the batch-control slips are filed by date.
>
> In the payroll accounting section payroll transaction cards are keypunched from the information on the time cards, and a batch total card for each batch is keypunched from the batch-control slip. The time cards and batch-control slips are then filed by batch for possible reference. The payroll transaction cards and batch total card are sent to data processing where they are sorted by employee number within batch. Each batch is edited by a computer program which checks the validity of employee number against a master employee tape file and the total hours and number of employees against the batch total card. A detail printout by batch and employee number is produced which indicates batches that do not balance and invalid employee numbers. This printout is returned to payroll accounting to resolve all differences.

In searching for documentation you found a flowchart of the payroll system which included all appropriate symbols (American National Standards Institute, Inc.) but was only partially labeled. The portion of this flowchart described by the above narrative appears below.

Required:

a. Number your answer 1 through 17. Next to the corresponding number of your answer, supply the appropriate labeling (document name, process description, or file order) applicable to each numbered symbol on the flowchart.

b. Flowcharts are one of the aids an auditor may use to determine and evaluate a client's internal control system. List advantages of using flowcharts in this context.



(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN BUSINESS LAW

(Commercial Law)

November 8, 1974; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	25	30
No. 2	25	30
No. 3	25	30
No. 4	35	40
No. 5	20	25
No. 6	25	30
No. 7	20	25
Total for examination	175	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered from 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The text of a letter from Bridge Builders, Inc., to Allied Steel Co. follows:

> We offer to purchase 10,000 tons of No. 4 steel pipes at today's quoted price for delivery two months from today. Your acceptance must be received in five days.

What type of contract did Bridge Builders intend to create?

a. Express.
b. Unilateral.
c. Bilateral.
d. Joint.

Answer Sheet

99. a. :::::::::: b. :::::::::: c. ▬▬▬ d. ::::::::::

Items to be Answered

1. Charles Norman and Walter Rockwell did business as the Norman and Rockwell Company. This relationship was very informal and neither party considered himself to be a partner of the other. Their stationery was printed with the name of Norman and Rockwell Company. Donald Quirk loaned Rockwell $10,000 for and on behalf of the business. Norman was informed of this but stated to Rockwell, "That's your responsibility; I had nothing to do with it." Rockwell defaulted and Quirk seeks to hold both Norman and Rockwell liable on the debt. Under these circumstances
   a. Quirk **cannot** recover against Norman because of Norman's statement to Rockwell, "That's your responsibility; I had nothing to do with it."
   b. Norman and Rockwell are partners by estoppel.
   c. Absent a signed partnership agreement, Quirk **cannot** recover against Norman.
   d. The fact that neither party considered their relationship to be a partnership precludes recovery against Norman.

2. The Statute of Frauds requires a written partnership agreement when the partnership
   a. By its terms has a duration of more than one year.
   b. Has assets in excess of $5,000.
   c. Is engaged in the real-estate business.
   d. Contains members who reside in different states.

3. Wyatt, Cooper, and Hubble informally agreed to share profits and losses. They agreed that each party would do business under his own name and **not** disclose the names of the other parties, and would assume liability for his own accounts. All parties lived up to the understanding. Unfortunately, Cooper overextended himself and, consequently, filed a voluntary petition in bankruptcy. Cooper's business creditors seek to assert rights against Wyatt and Hubble. Under these circumstances
   a. Wyatt and Hubble are partners by estoppel.
   b. Wyatt and Hubble can rely upon the Statute of Frauds to defeat the claims of Cooper's creditors.
   c. Cooper's activities were *ultra vires*, hence, **not** binding on Wyatt and Hubble.
   d. Wyatt, Cooper, and Hubble are partners *inter se* (i.e., among themselves) and, hence, are all liable for Cooper's debts.

4. Webster, Davis, and Polk were general partners in the antique business. Webster contributed his illustrious name, Davis managed the partnership, and Polk contributed the capital. Absent an agreement to the contrary, which of the following provisions would automatically prevail?
   a. Polk has the majority vote in respect to new business.
   b. Polk has assumed the responsibility of paying Webster's personal debts upon insolvency of the partnership.
   c. Webster, Davis, and Polk share profits and losses equally.
   d. Davis is entitled to a reasonable salary for his services.

5. For federal income tax purposes, a partnership is
   a. A taxable entity similar to a trust or an estate.
   b. Considered to be a nontaxable entity but which must file an information return.
   c. Treated the same as an association for tax purposes.
   d. Required to pay a tax upon its profits which in turn must be assumed by its partners.

6. In 1970, Allen, Burton, and Carter became equal partners for the purpose of buying and selling real estate for profit. For convenience, title to all property purchased was taken in the name of Allen. Allen died with partnership real

estate and partnership personal property standing in his name valued at $25,000 and $5,000, respectively. The partnership had no debts. Allen's wife claims a dower right in the real property. Allen had bequeathed all his personal property to his children who claim an absolute one-third interest in the $5,000 of personal property. In this situation

a. Allen's wife has a valid dower right to all the real property held in her deceased husband's name.
b. Partnership property is subject to a right of survivorship in the surviving partners; hence, Allen's wife is entitled only to his share of undistributed partnership profits.
c. Allen's children are entitled to one-third of all partnership personal property.
d. Allen's estate is entitled to settlement for the value of his partnership interest.

7. General Cosmetics, a limited partnership created pursuant to the Uniform Limited Partnership Act, is in liquidation. Some of the limited partners are also creditors of the partnership. Under the circumstances, how should the liquidation be accomplished?

a. First satisfy all creditors, including any creditors who are also limited partners, in order of priority as provided by law.
b. Distribute any excess remaining after the satisfaction of creditors to limited partners with the exception of undistributed profits to which the general partners may be entitled.
c. Satisfy all outside creditors, excluding any limited partners who are also creditors, and then satisfy limited partners for all their claims.
d. Satisfy all partners whether general or limited for their original capital contributions after all creditors have been satisfied.

8. Williams, Watkins, and Glenn is a limited partnership. At present, there are three general partners and sixteen limited partners. The partnership is engaged in the grain-futures business. The general partners decided to expand the business substantially by offering one million dollars of limited-partner interests to the investing public in several states at $5,000 per limited-partner interest. A majority of the existing limited partners object to the proposition. Under the circumstances, the limited partnership

a. Has been dissolved.
b. Must file a registration statement with the SEC if it is going to offer the one million dollars of limited-partner interests to prospective buyers.
c. Is exempt from federal registration because a limited-partner interest is **not** a "security."
d. Is recognized as a general partnership as a result of the dispute between the general and limited partners and each is entitled to an equal vote in the management of the partnership.

9. Badger Corporation engaged Donald Keller as one of its sales representatives to sell automotive parts. Keller signed an employment contract which required him to obtain home-office approval on any contract in excess of $500 entered into by Keller on Badger's behalf. The industry custom and most of Badger's agents had authority to make such contracts if they did **not** exceed $1,000. Keller signed a contract on Badger's behalf with Zolar Garages, Inc., for $850. Badger rejected the contract and promptly notified Zolar of its decision. Under these circumstances

a. Keller is a *del credere* agent.
b. Keller did **not** have express authority to make the Zolar contract.
c. Keller had the implied authority to make the contract.
d. Badger's prompt disaffirmance of Keller's action retroactively terminated any liability it might have had.

10. An agent for an undisclosed principal

a. Has less express authority than would be the case if he were acting as an agent for a disclosed principal.
b. Has liability on a contract he made with a third party, if the third party elects to hold him liable thereon.
c. Must derive whatever authority he may have from a written power of attorney.
d. Must disclose his principal's identity prior to performance.

11. An agent's power to bind his principal to a contract is generally terminated

a. Automatically upon the commission of a tort by the agent.
b. Instantly upon the death of the principal.
c. Upon the bankruptcy of the agent.
d. Without further action by the principal upon the resignation of the agent.

12 A creditor who receives a preference payment from a bankrupt debtor will

a. Be barred from any recovery on his claim.
b. Lose it if he knew or had reason to know that the debtor was insolvent in the bankruptcy sense.
c. Have a priority even if the preference is voidable.
d. Have committed a bankruptcy offense.

13. A discharge in bankruptcy

a. Relieves the debtor from all provable debts.
b. Is **not** available if the debtor was previously discharged within ten years prior to the present bankruptcy.
c. **Cannot** be revoked.
d. Is barred if the debtor commits a bankruptcy offense.

14. Joe Walters was employed by the Metropolitan Department Store as a driver of one of its delivery trucks. Under the terms of his employment he made deliveries daily along a designated route and brought the truck back to the store's garage for overnight storage. One day instead of returning to the garage as required, he drove the truck twenty miles north of the area he covered expecting to attend a social function unrelated to his employment or to his employer's affairs. Through his negligence in operating the truck while enroute, Walters seriously injured Richard Bunt. Walters caused the accident and was soley at fault. Bunt entered suit in tort against the store for damages for personal injuries, alleging that the store, as principal, was responsible for the tortious acts of its agent. Under these circumstances

a. Metropolitan is **not** liable because Walters was an independent contractor.
b. Metropolitan is **not** liable because Walters had abandoned his employment and was engaged in an independent activity of his own.
c. Metropolitan is liable based upon the doctrine of *respondant superior.*
d. Bunt can recover damages from both Walters and Metropolitan.

15. Insolvency in the bankruptcy sense

a. Is the same as insolvency in the equity sense.
b. Must be present if the debtor seeks to file a voluntary petition in bankruptcy.
c. Is normally easier to establish than insolvency in the equity sense.
d. Is a financial status in which the liabilities exceed the aggregate fair value of the assets.

16. Six months ago Harold Walsh borrowed $4,000 from the First Financial Credit Corporation. At that time, First Financial requested and received collateral valued at $4,500. Other creditors filed an involuntary petition in bankruptcy against Walsh one week ago. First Financial has since sold the collateral it held for its fair market value. Under these circumstances

a. First Financial has a voidable preference.
b. If the collateral sold did **not** equal the amount due on the loan, First Financial has a priority over general creditors.
c. The taking of $4,500 collateral to secure a $4,000 loan is a fraudulent conveyance.
d. If the collateral held was of insufficient value to satisfy the debt, First Financial may file a claim in bankruptcy for any deficiency on the loan to Walsh.

Number 2 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

17. An outstanding offer to sell a tract of real property is terminated at the time the

a. Buyer learns of the seller's death.
b. Seller posts his revocation if the original offer was made by mail.
c. Buyer posts a rejection of the offer if the original offer was received by mail.
d. Buyer learns of the sale of the property to a third party.

18. Donaldson Retailers engaged in lengthy negotiations for the purchase of an office building from Universal Real Estate, Inc. The parties reached an impasse on the price. Universal's written offer to sell was $150,000. Donaldson replied by telegram offering $140,000 — "Take it or leave it." Universal filed the telegram away for future reference but did **not** respond. Donaldson then sent a letter stating that Universal was to disregard its prior communication and that it accepted the offer at $150,000. Universal wrote back stating, "The price is now $160,000 — take it or leave it." Donaldson promptly telegraphed Universal that it held Universal to its original offer of $150,000. Under these circumstances

a. The purported contract is unenforceable in any event under the Statute of Frauds.
b. No contract was formed.
c. Since the same means of communication was **not** used throughout the transaction, there can be **no** contract.
d. Donaldson's reply offering $140,000 constituted a mere counter proposal which did **not** terminate the original offer.

19. Martin Finance Corporation loaned David Small $2,500. Small agreed to repay in twelve monthly installments. After Small was late in making a payment, Martin indicated it needed additional protection and requested that Small obtain a surety. Small appealed to his long-time friend, Arthur Black, to help him. As a personal favor to

Small, Black agreed and gave Small a written promise to answer for the debt in the event Small should default on the loan. Small defaulted and filed a voluntary petition in bankruptcy. Martin immediately demanded payment by Black. In this situation

a. Black's undertaking was **not** supported by consideration; hence, it is unenforceable.
b. Martin must wait until the bankruptcy proceeding has been concluded and the bankrupt's estate distributed to creditors.
c. The Statute of Frauds would **not** apply to Black's undertaking because he was a noncompensated surety.
d. Small's bankruptcy bars Martin from recovery against Black.

20. Winslow Enterprises, Inc., sought an increased line of credit from New National Bank. New National insisted that Winslow obtain an acceptable surety. Winslow's president persuaded Peter Josephs, a Winslow board member and major stockholder, to agree to become its surety. Josephs stipulated, however, that he would become the surety only if he could do so as a conditional guarantor. New National was unhappy about the arrangement, but it agreed to accept Josephs' conditions because he was an excellent customer and a multimillionaire. Under these circumstances

a. The surety agreement need **not** be in writing because it was directly beneficial to Josephs.
b. New National must first give timely notice of default to Josephs and then proceed to judgment against Winslow before it can collect from Josephs.
c. There is a conflict of interest between Josephs and Winslow which necessitates his resignation as a Winslow board member.
d. The rights, duties, and obligations of Josephs as a conditional guarantor are the same as those of a usual surety.

21. The Statute of Frauds

a. Does **not** require that all the terms and provisions of the agreement of the parties be contained in a single document.
b. Requires that both parties sign the written contract.
c. Defines what constitutes fraudulent conduct by a party in inducing another to make a contract.
d. Applies to all contracts which by their terms require the payment of $500 or more.

22. The common-law contract doctrine of consideration

a. Requires that consideration have a monetary value if it is to be valid.
b. Recognizes that the forebearance from a legal right constitutes consideration.
c. Has been abolished in most jurisdictions if the contract is made under seal.
d. Requires a roughly equal exchange of value by the parties to the contract.

23. Charles Lands offered to sell his business to Donald Bright. The assets consisted of real property, merchandise, office equipment, and the rights under certain contracts to purchase goods at an agreed price. In consideration for receipt of the aforementioned assets, Bright was to pay $125,000 and assume all business liabilities owed by Lands. Bright accepted the offer and a written contract was signed by both parties. Under the circumstances, the contract

a. Represents an assignment of all the business assets and rights Lands owned and a delegation of whatever duties Lands was obligated to perform.
b. Must be agreed to by all Lands' creditors and the parties who had agreed to deliver goods to Lands.
c. Frees Lands from all liability to his creditors once the purchase is consummated.
d. Is too indefinite and uncertain to be enforced.

24. The parol evidence rule

a. Requires that certain types of contracts be in writing.
b. Precludes the use of oral testimony to show that a written contract was fraudulently obtained.
c. Eliminates the requirement of consideration if the rule is satisfied.
d. Does **not** prohibit a subsequent oral modification of a written contract.

25. In order to have a co-surety relationship

a. Each surety must sign the original loan and surety agreement at the time credit is extended.
b. Each surety must be bound to answer for the same duty and share in the loss upon default.
c. The creditor must agree to proceed against them jointly in the event of default.
d. Any collateral provided by the debtor must be held jointly or divided equally among the sureties.

26. Alfred Matz negotiated with Basic Construction Company, Inc., to construct an apartment house. Desiring additional assurance of completion or payment of damages in the event of default, Matz insisted that a performance bond be posted. Basic obtained First Fidelity Surety Bonding Company as the surety on the undertaking. In addition to the normal terms of such contracts, First Fidelity insisted upon the right to complete the building in the event of default by Basic. The contract was drafted and signed by all the parties involved. Under the circumstances

a. Basic Construction is the third-party beneficiary of the contract.
b. If Basic Construction refuses to perform, Matz can obtain a court order obligating First Fidelity to complete construction.
c. First Fidelity has assumed the primary obligation to perform.
d. First Fidelity would be entitled to any and all rights that Matz would have against Basic in the event Basic defaults and First Fidelity pays.

27. Lester Dunbar sold to Walter Masters real property on which Charles Endicott held a first mortgage which had been created at the time Dunbar purchased the property. Under the terms of the written purchase agreement, Masters expressly assumed the mortgage debt. Subsequent to the purchase, Masters defaulted in his payment of the mortgage debt. Endicott thereupon sought to enforce payment of the mortgage debt against Masters personally. Masters contends that Endicott should have proceeded against Dunbar, the original mortgagor, because he is primarily liable for the mortgage debt. Based upon the above facts

a. Masters is correct in his assertion.
b. Endicott lost all rights against Dunbar upon learning of the sale to Masters and having made **no** objection thereto.
c. Dunbar is, in fact, a surety and must satisfy the mortgage if Masters does **not.**
d. Upon default, Endicott must elect to proceed against one of the parties involved and by so doing has made a binding election, thereby releasing the other.

28. William Joyce, a creditor, has instituted suit seeking recovery from Howard Frank as a surety. Frank's **best** defense would be to assert

a. The debtor's infancy.
b. Fraud by the debtor which induced him to act as surety.
c. Tender of performance by the debtor.
d. Failure of the creditor to first proceed against the debtor.

29. George Parker wanted to purchase certain goods on credit from Charles Stabel with terms of payment of 2/10, net 30. Stabel required a surety on the obligation before he would agree to Parker's credit terms. As a personal favor, Sam Hayes, a well-known financier and friend, assumed the role as surety on the contract with Stabel. The goods were shipped to Parker on open account with the terms 2/10, net 30. **Not** having received payment after 20 days, Stabel went to Parker and persuaded him to execute a promissory note for the amount owed with the stipulation that payment would **not** be due until two months from the date of execution. Parker subsequently defaulted on the note, and Stabel sued Hayes on his surety promise. Under these circumstances

a. Hayes' undertaking need **not** be in writing because it was gratuitous.
b. Sale of the Parker note by Stabel would automatically release Hayes from all liablity.
c. Stabel's binding extension of time via the note relieved Hayes from liability.
d. Hayes may withdraw from the surety agreement by giving prompt notice to Stabel prior to the extension of credit.

30. The Fair Labor Standards Act

a. Applies to all employers whether or **not** engaged in interstate commerce.
b. Requires that double time be paid to any employee working in excess of eight hours in a given day.
c. Prohibits discrimination based upon the sex of the employee.
d. Requires all employees doing the same job to receive an equal rate of pay.

31. Workmen's compensation laws are

a. Governed by federal regulation.
b. Applicable to all types of employment.
c. Designed to eliminate the usual defenses by the employer, such as contributory negligence, when an employee is injured.
d. **Not** applicable if the employee signs a waiver and consents to his noncoverage under workmen's compensation at the time he is hired.

32. Martin Wilson was hired by Gismore Enterprises, Inc., an an operator of a drill press. Gismore is fully covered by workmen's compensation insurance. Wilson did **not** believe in the safety regulations posted by management; hence, he removed the protective shields designed to prevent any possible injury to his hands. In this way he could meet production standards with a minimal effort and collect production bonuses. In the process of his work, Wilson Unfortunately caught his hand in the drill press and the operating physician decided that amputation was the only alternative if Wilson's life were to be saved. Wilson seeks to recover. In this situation

a. Wilson can recover in negligence against Gismore.
b. Wilson will be denied all recovery because of his assumption of the risk.
c. If Wilson was working overtime, workmen's compensation rules would **not** apply.
d. Even if Wilson is guilty of contributory negligence, workmen's compensation rules provide for recovery.

Number 3 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

33. Delray Corporation has a provision in its corporate charter as follows: "Holders of the noncumulative preferred stock shall be entitled to a fixed annual dividend of 8% before any dividend shall be paid on common stock." There are **no** further provisions relating to preferences or statements regarding voting rights. The preferred stock apparently

a. Is noncumulative, but only to the extent that the 8% dividend is **not** earned in a given year.
b. Is nonvoting unless dividends are in arrears.
c. Has a preference on the distribution of the assets of the corporation upon dissolution.
d. Is **not** entitled to participate with common stock in dividend distributions beyond 8%.

34. As the owner of common stock in a corporation, you will **not** have liability beyond actual investment even if you

a. Paid less than par value for stock you purchased in connection with an original issue.
b. Fail to pay the full amount owed on a subscription contract for no-par stock.
c. Purchased treasury stock for less than par value.
d. Received a dividend distribution which impaired the legal capital of the corporation.

35. Under which of the following circumstances would a corporation's existence terminate?

a. The death of its sole owner-shareholder.
b. Its becoming insolvent.
c. Its legal consolidation with another corporation.
d. Its reorganization under the federal bankruptcy laws.

36. Donald Walker is a dissident stockholder of the Meaker Corporation which is listed on a national stock exchange. Walker is seeking to oust the existing board of directors and has notified the directors that he intends to sue them for negligence. Under the circumstances, Walker

a. Can be validly denied access to the corporate financial records.
b. Can be legally prohibited from obtaining a copy of the stockholder list because his purpose is **not** bona fide.
c. Must show personal gain on the part of the directors if he is to win his lawsuit.
d. Can insist that the corporation mail out his proxy materials as long as he pays the cost.

37. Weber Corporation was incorporated in the State of Delaware. It does all of its business in several adjoining states. Under the circumstances

a. Weber's Delaware incorporation was invalid because it does **no** business there.
b. Weber is a domestic corporation in all states based upon full faith and credit.
c. Weber will **not** have to pay corporate income taxes except to Delaware and the United States.
d. Weber should either incorporate in the adjoining states where it does business or otherwise qualify to do business therein.

38. Walter Thomas as the promoter of Basic Corporation made a contract for and on behalf of Basic with Fair Realty Corporation for the purchase of an office building. Thomas **did not** disclose that the corporation had **not** been created. Thomas will **not** have any liability on the contract

a. Because he made it in the name of the corporation.
b. If the corporation subsequently adopts the contract.
c. If the corporation and Fair Realty enter into a novation regarding the contract.
d. If the corporation comes into existence and rejects the contract.

39. The Zebra Corporation is neither *de jure* nor *de facto.* As such it

a. Can nevertheless recover on a loan which it made to one of its suppliers.
b. **Cannot** be held liable for torts committed by its agents.
c. **Cannot** be treated as a corporation for tax purposes.
d. Can nevertheless validly continue to do business as a corporation without fear of legal action by the state as long as it is solvent and pays taxes.

40. James Fisk recently acquired Valiant Corporation by purchasing all of its outstanding stock pursuant to a tender offer. Fisk demanded and obtained the resignation of the existing board of directors and replaced it with his own slate of nominees. Under these circumstances

a. Fisk had **no** right to demand the resignation of the existing board members; their resignations are legally ineffective and they remain as directors.
b. If Valiant is listed on a national stock exchange, Fisk would have to file his tender offer with the Securities and Exchange Commission.
c. The former stockholders of Valiant are parties to a tax free reorganization; hence, they are **not** subject to federal income tax on their gain, if any, on transferring their stock to Fisk.
d. If Valiant is engaged in interstate commerce, the acquisition is exempt under the antitrust laws because the Securities and Exchange Commission has jurisdiction.

41. Hiller Corporation is the largest nationwide distributor of automotive parts. Visco Corporation is its leading competitor. Hiller is seeking to acquire Visco or obtain an agreement with Visco to sell their competing products at the same price. Under these circumstances

a. An agreement between Hiller and Visco to sell parts at the same price is legal as long as the price is reasonable.
b. Assuming Hiller acquires Visco, the Justice Department may **not** stop the acquisition unless it objected to the anticipated merger.
c. If Hiller and Visco agree to fix prices, they are *per se* in violation of the antitrust laws.
d. If Hiller acquires Visco and shows that its prices are reasonable, it will **not** be in violation of the antitrust laws.

42. Nashville Baseball Corporation has a contract that provides it with exclusive rights to supply baseballs to the National and American Baseball Leagues as long as it meets the price and quality of baseballs offered by competitors. Excelsior Corporation offered a superior baseball at a reduced price. Nashville met the quality and price proposal submitted by Excelsior and retained its exclusive suppliership. Under these circumstances

a. If Nashville meets the price and quality offer of Excelsior, it has **not** violated the federal antitrust laws.
b. Nashville has obtained an exclusive dealing arrangement which will be tested under the provisions of the Clayton Act.
c. Nashville is **not** engaged in interstate commerce because it sells all its baseballs to the league buyers in Tennessee.
d. Nashville has **not** violated the antitrust laws because it must meet competition from other suppliers.

43. George Corporation entered into contracts to supply all of the requirements of 1,000 dealers in New England. In these contracts the dealers agreed **not** to sell products competitive with those of George. These dealers constituted 20% of the total number of dealers in the area. George Corporation may

a. Be enjoined from enforcing the contracts if they might substantially lessen competition.
b. Be enjoined only to the extent that its own outlets operated by its agents are involved.
c. **Not** be enjoined because only 20% of the New England dealers are involved.
d. Be enjoined for violating the Robinson-Patman Act.

44. Territorial allocation of competitors' markets is

a. Subject to the rule of reason.
b. A *per se* violation of the Sherman Act.
c. Never a *per se* violation of the Sherman Act.
d. Legal if the allocation involves territories rather than customers.

45. The Waller Corporation competes with the Graves Corporation in interstate commerce. Without communicating with Graves or anyone else, Waller decided **not** to sell to Redondo Company who had ordered certain products from Waller. Redondo then sued Waller for damages pursuant to the antitrust laws. Redondo claims damages of $50,000 for loss of profits and capital. In this situation, Waller is

a. Liable to Redondo for $150,000.
b. Liable to Redondo for $50,000.
c. Liable to Redondo only for loss of capital.
d. **Not** liable to Redondo.

46. FunTime Corporation sells transistor radios in interstate commerce for $2.75 per radio to Birchall, Devlin, Cates, and Rosenthal, each sole proprietors. The radios cost $2.00 each to make. Mahoney Corporation, a competitor of FunTime, has legally offered to sell the same product to Birchall at $2.50 each. FunTime then in good faith sold the radios to Birchall at $2.50 each. Birchall, Devlin, Cates, and Rosenthal compete with one another. Under these circumstances FunTime is

a. Liable to Devlin, Cates, and Rosenthal for price discrimination.
b. Liable to Mahoney Corporation for price discrimination.
c. Liable to Mahoney Corporation for unlawful predatory price cutting.
d. **Not** liable for price discrimination.

47. White Corporation acquired 100% of the stock of King Corporation, a competitor of White. Both companies are of substantial size with respect to their involvement in interstate commerce. This acquisition would

a. Be legal under the Clayton Act unless the acquisition were certain to create a monopoly in any line of commerce in any section of the country.
b. Constitute a *per se* violation under the Clayton Act.
c. Be illegal under the Clayton Act if its effect might be to substantially lessen competition.
d. Be illegal under the Clayton Act only if its effect were certain to lessen competition substantially.

48. The Sherman Act is **not** directed at trade restraints involving
    a. Monopolization.
    b. Attempts to monopolize.
    c. Contracts and combinations.
    d. Price discrimination.

Number 4 (Estimated time –– 35 to 40 minutes)

Part a. On July 1, 1974, Franklin Novelties, Inc., offered to sell Major Toy Marketing Corporation twelve-thousand velocipedes at $6.25 each, delivery FOB Franklin's warehouse not later than December 15, 1974.

Major Toy wired Franklin as follows:

> "We accept your offer of July 1, 1974. However, due to the proximity of the Christmas season, we must insist that delivery be made not later than November 1, 1974. This acceptance is expressly made conditional on your assent to the different delivery date.
>
> Major Toy."

Franklin decided to stick with its original terms and, consequently, sold the twelve-thousand velocipedes to Fremont Toys. It, therefore, ceased entirely its dealings with Major Toy.

Major Toy subsequently learned of the sale to its competitor, Fremont Toys, and promptly dispatched to Franklin the following telegram:

> "We hold you liable on your offer of July 1, 1974, re the sale of twelve-thousand velocipedes. Our modification of the terms was a mere proposal, which we herewith waive. In any event, your silence constitutes acceptance of our modified terms. We expect delivery not later than December 15, 1974.
>
> Major Toy."

Required:

What are the legal implications to Franklin Novelties as a result of the above facts? Explain.

Part b. During your examination of the financial statements of Wyatt Associates, Inc., for the fiscal year ended June 30, 1974, you discovered the following facts relating to a transaction with Flinko Corporation. The transaction occurred during April 1974.

Flinko, one of Wyatt's major competitors, was insolvent in the equity sense, i.e., it could not meet the claims of its current creditors. Wyatt offered to purchase all of Flinko's assets including furniture, fixtures, equipment, materials, supplies, inventory, and any and all other assets owned by Flinko. Wyatt's offering price equaled 105% of the total of all outstanding claims of Flinko's creditors. Flinko agreed to satisfy all creditors' claims out of the proceeds of sale and to hold Wyatt harmless from any claims of creditors. Meglo, Flinko's president and sole stockholder, accepted the offer. However, Meglo notified no one of the sale, absconded with the entire proceeds, and has not been heard from since.

Required:

Discuss the legal and the financial-reporting implications of the above transaction to Wyatt. **Ignore antitrust considerations.**

Part c. Wonder Television Manufacturing, Inc., manufactures television sets under its brand name, Wonder TV, and sells the sets directly to retail stores. To increase sales, Wonder incorporated WOMAC Financial Corporation to provide credit to customers who purchase Wonder TV sets from the retail stores. Wonder's arrangement with the retailers stipulates that WOMAC will provide the financing for the purchase of Wonder TV sets to any customer who meets WOMAC's financial requirements. These financial requirements are based on standard credit practices. The financing is put in motion by the retailers telling their customers that financing is available through WOMAC if they wish to purchase a set on time.

After a recent analysis of its experience, WOMAC has found that it would be cheaper not to file a financing statement covering each individual set purchased by the retailers' customers. As a result, WOMAC is considering an alternative plan whereby WOMAC will take a negotiable promissory note and a security agreement signed by the borrower-purchaser. These papers will be retained by WOMAC, and monthly collections will be made on the notes. The retailers will receive immediate payment on a discounted basis for each sale financed.

Required:

Assuming WOMAC implements its alternate plan, discuss its rights against each of the following:

1. A retailer upon the default by one of its customers who purchased a Wonder TV financed by WOMAC.
2. The creditors or the trustee in bankruptcy of a purchaser of a Wonder TV financed by WOMAC in the event of default by the purchaser.
3. A subsequent bona fide purchaser who bought a used set from an original retail customer who had financed his original purchase through WOMAC.

Number 5 (Estimated time — 20 to 25 minutes)

Part a. Carter, Wilson, and Whipple, CPAs, were engaged to examine the financial statements of Devon Corporation for the year ended September 30, 1974. The capital stock of Devon is traded on the Pacific Coast Stock Exchange.

During the engagement it was discovered that Devon had been making large, unsecured loans on favorable terms to Carbal Corporation. All of the stock of Carbal is held by a majority of the board of directors of Devon.

Required:

Discuss the professional and legal responsibilities of Carter, Wilson, and Whipple.

Part b. While examining the financial statements of Fesmore Industries, Inc., for the fiscal year ended October 31, 1974, Dey & Co., CPAs, discovered that J. Parker Dilmore, executive vice president of Fesmore, was actively involved in trading Fesmore's common stock. While Dilmore has always owned at least 100,000 shares of Fesmore's common stock, he executed the following specific transactions during the year under examination.

Transaction	*Number of Shares*	*Date*	*Price per Share*
Purchased	15,000	March 1, 1974	$24
Sold	15,000	June 5, 1974	40
Purchased	5,000	June 7, 1974	35
Sold	5,000	September 3, 1974	30
Purchased	5,000	October 2, 1974	25

The stock sold on June 5 and September 3, 1974, was the same stock purchased on March 1 and June 7, 1974, respectively.

Required:

Discuss the legal implications of the facts discovered by Dey & Co.

Part c. Barney & Co., CPAs, has been engaged to perform an examination of the financial statements of Waldo, Inc., for several years. The terms of the engagement have been set out in an annual engagement letter signed by both parties. The terms of each engagement included the following:

> This being an ordinary examination, it is not primarily or specifically designed, and cannot be relied upon, to disclose defalcations and other similar irregularities, although their discovery may result.

Three years ago Harold Zamp, head cashier of Waldo and an expert in computer operations, devised a previously unheard of method of embezzling funds from his employer. At first, Zamp's thefts were small but increased as time went on. During the current year, before Barney began working on the engagement, the thefts became so large that serious variances in certain accounts came to the attention of the controller. When questioned about the variances, Zamp confessed and explained his unique embezzlement scheme. Investigation revealed that Zamp had stolen $257,550. Zamp has no assets with which to repay the thefts.

Waldo submitted its claim for $257,550 to Multi-State Surety Company in accordance with the terms of the fidelity bond covering Zamp. Fulfilling its surety obligation, Multi-State paid the claim and now seeks to recover its losses from Barney.

In defense, Barney asserts, in the alternative, the following defenses:

1. Multi-State has no standing in court to sue because it was not a party to the contract (i.e., lacking in privity) between Barney and its client, Waldo.
2. Even if Multi-State had the standing to sue, its claim should be dismissed because Barney's engagements with Waldo did not specifically include the discovery of defalcations other than those which might arise in the process of an ordinary examination.
3. Even if Barney's contract had made it responsible for discoverable defalcations, it could not have discovered Zamp's defalcations with the exercise of reasonable care. Zamp's technique was so new, unique, and novel that no accounting firm could have discovered the defalcations in any event.

Required:

In separately numbered paragraphs, discuss the validity of each of Barney's defenses.

Number 6 (Estimated time –– 25 to 30 minutes)

Part a. Magnum Enterprises, Inc., received a note from one of its major customers, Bilbo Sales, Inc., in connection with the purchase of $100,000 of merchandise. The note provided as follows:

August 1, 1974

Bilbo Sales, Inc., hereby promises to pay Magnum Enterprises, Inc., One Hundred Thousand Dollars ($100,000) within thirty days from August 1, 1974, for the purchase of goods delivered on July 26, 1974, receipt of which is hereby acknowledged. Bilbo Sales hereby confesses judgment on said note and agrees to pay any and all costs of collection in the event of wrongful default.

Walter Bilbo,
President

Magnum had promptly discounted the note with the Third National Bank.

Upon examination of the merchandise, Bilbo promptly informed Magnum that the goods were not as warranted. Magnum responded by informing Bilbo that the note had been sold to Third National Bank and that whatever problems it had must first be resolved with the bank because it was the holder in due course.

Required:

In the event that Bilbo was properly dissatisfied with the merchandise, can it assert the defense of breach of warranty against Third National? Explain.

Part b. Herman Watts sold a used printing press to Marshall Offset, Inc., for two thousand dollars ($2,000). Watts requested that Marshall make the check payable to the order of the Foremost Finance Company because Watts was in arrears on a loan it owed to Foremost. That same day Watts delivered the check to Foremost which, in turn, presented the check and received payment from Marshall's bank.

Marshall subsequently discovered serious defects in the printing press purchased from Watts. The defects unquestionably represented a breach of the express warranties given by Watts in the contract of sale. Immediately upon discovery of the defect, Marshall notified his bank to stop payment but this was several days after the bank had processed the check.

Watts is hopelessly insolvent. Marshall seeks to rescind the transaction and recover the payment on the check from Foremost or its own bank.

Required:

What legal remedies are available to Marshall in the situation described? Explain.

Part c. On July 1, 1974, Martin Hayes signed a promissory note which was made payable to the order of Jones Fabricating, Inc., for $10,000, plus 8% interest, payable 90 days from date. On the front of the note above his signature Hayes wrote: "Subject to satisfactory delivery of goods purchased this date. Delivery to be made no later than July 31, 1974."

Jones' president indorsed the note on behalf of the corporation and transferred it to Acme Bank in consideration of the bank's crediting $9,800 against a $20,000 debt owed to the bank by Jones Fabricating.

When the due date arrived the bank asked Hayes to pay, but Hayes refused saying that Jones had not delivered the goods he had bargained for in giving the note. Acme Bank gave notice of dishonor the next day to Jones.

Required:

1. Is the note negotiable commercial paper? Explain.
2. Assuming the note is nonnegotiable paper, can Acme Bank collect the amount due from Hayes if Hayes can prove that the goods he bargained for were not delivered? Explain.
3. Assuming the note is negotiable, can Acme Bank successfully collect from Hayes? Explain.
4. Assuming the note is negotiable and that Acme Bank is a holder in due course, can it successfully sue Jones Fabricating to collect the proceeds of the note? Explain.

Number 7 (Estimated time -- 20 to 25 minutes)

Part a. In the course of your examination of the financial statements of Lomax Manufacturing, Inc., you discovered the following facts relating to a real-estate transaction by the company during the current year.

Lomax purchased from Dunbar Corporation four acres of land in a proposed industrial-park site for $45,000. At the closing, Dunbar delivered to Lomax a bargain and sale deed with a covenant against the grantor's acts. Guaranty Indemnity Company wrote a title insurance policy for $45,000 covering the transaction.

Lomax disclosed to you that it recently learned of a defect in its title to the four acres of land due to a restriction placed on the land by John Jason, a former owner. Jason had included in his warranty deed a covenant "...that the land should be used exclusively for residential purposes." Jason's warranty deed was to an owner preceding Dunbar and conveyed all of the land now included in the proposed industrial park as well as surrounding land which has been developed for residential purposes. As a result of this restriction the value of the land acquired by Lomax has decreased by $15,000 according to an independent appraisal. Guaranty Indemnity had failed to discover this restriction at the time Lomax acquired the property.

Required:

Discuss the rights of Lomax against the following:

1. Dunbar Corporation.
2. Guaranty Indemnity Company.

Part b. You are in the midst of your annual examination of the financial statements of Winkler Corporation which is engaged in residential land development. Early in the engagement you learned that the company intended to subdivide a tract of land it had acquired for $150,000 several years ago and then undertake an active advertising and sales campaign to sell the home sites. The land has been recorded on the company's books and reported on its balance sheet at $150,000 since acquisition.

While investigating the costs of subdividing the tract you learn that the county where the tract is located has offered $100,000 for the land to convert it into a community park. You also learn that if Winkler refuses this offer, the county has indicated in writing that it will institute legal proceedings to condemn the property at $100,000.

Required:

Discuss the legal implications of the above facts and how they should affect the financial statements of Winkler Corporation.

Part c. Marvel Enterprises, Inc., contracted to buy Jonstone's factory and warehouse. The contract provided that if title did not pass to Marvel prior to October 1, 1974, Marvel would have the right to possession on that date pending conveyance of title upon delivery of the deed. The contract also provided that the purchase price was to be adjusted depending upon the actual acreage conveyed as determined by an independent survey. This provision was subject to a further stipulation: the maximum purchase price would not exceed $450,000 nor be less than $425,000 as long as the survey did not reveal major variances nor render title unmarketable.

All the requisite paperwork was not in order by October 1, 1974, and Marvel exercised its option to take possession on that date. Concurrently, Marvel obtained a fire insurance policy on the factory and warehouse effective October 1, 1974. The closing was finally scheduled for October 17, 1974. The survey confirmed the acreage described in the contract of sale, and Marvel tendered the balance of the purchase price on October 17, 1974. During the interim period, however, the factory and warehouse were totally destroyed by fire and Marvel seeks to recover on its fire insurance policy. The insurance company denies liability.

Required:

Discuss Marvel's rights to recover from the insurance company.

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING THEORY

(Theory of Accounts)

November 8, 1974; 1:30 to 5:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	25	30
No. 2	25	30
No. 3	25	30
No. 4	25	30
No. 5	25	30
No. 6	25	30
No. 7	25	30
Total for examination	175	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of issues in financial accounting.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The recommended title for the financial statement which summarizes changes in financial position is the statement of
    - a. Changes in financial position.
    - b. Changes in working capital.
    - c. Sources and applications of funds.
    - d. Cash flow.

Answer Sheet

99. a. ▬▬▬ b. :::::::::: c. :::::::::: d. ::::::::::

Items to be Answered

1. As generally used, the term "net assets" represents
    - a. Retained earnings of a corporation.
    - b. Current assets less current liabilities.
    - c. Total paid-in capital of a corporation.
    - d. Total assets less total liabilities.

2. Postage stamps and IOUs found in cash drawers should be reported as
    - a. Supplies and receivables.
    - b. Cash because they represent the equivalent of money.
    - c. Petty cash.
    - d. Investments.

3. How is the premium or discount on bonds purchased as a temporary investment generally reported in published financial statements?
    - a. As an integral part of the cost of the asset acquired (investment) and amortized over a period of not less than 60 months.
    - b. As an integral part of the cost of the asset acquired (investment) until such time as the investment is sold.
    - c. As expense or revenue in the period the bonds are purchased.
    - d. As an integral part of the cost of the asset acquired (investment) and amortized over the period the bonds are expected to be held.

Items 4 through 9 deal with the calculation of ratios and the determination of other factors considered important in analysis of financial statements. Prior to the occurrence of the independent events described below the corporation concerned had current and quick ratios in excess of one to one and reported a net income (as opposed to a loss) for the period just ended. Income tax effects of the events are to be ignored. The corporation had only one class of shares outstanding.

4. The effect of recording a 100% stock dividend would be to
    - a. Decrease the current ratio, decrease working capital, and decrease book value per share.
    - b. Leave inventory turnover unaffected, decrease working capital, and decrease book value per share.
    - c. Leave working capital unaffected, decrease earnings per share, and decrease book value per share.
    - d. Leave working capital unaffected, decrease earnings per share, and decrease the debt to equity ratio.

5. Recording the payment (as distinguished from the declaration) of a cash dividend whose declaration was already recorded will
    - a. Increase the current ratio but have **no** effect on working capital.
    - b. Decrease both the current ratio and working capital.
    - c. Increase both the current ratio and working capital.
    - d. Have **no** effect on the current ratio or earnings per share.

6. What would be the effect on book value per share and earnings per share if the corporation purchased its own shares in the open market at a price greater than book value per share?
    - a. **No** effect on book value per share but increase earnings per share.
    - b. Increase both book value per share and earnings per share.
    - c. Decrease both book value per share and earnings per share.
    - d. Decrease book value per share and increase earnings per share.

7. If the corporation were to increase the extent to which it successfully "traded on the equity" this fact would likely be manifested in a combination of facts that its
    - a. Ratio of owners' equity to total assets decreased while its ratio of net income to owners' equity increased.
    - b. Book value and earnings per share decreased.
    - c. Working capital decreased while its current ratio increased.
    - d. Asset turnover and return on sales both decreased.

8. The corporation exercises control over an affiliate in which it holds a 40% common stock interest. If its affiliate completed a fiscal year profitably but paid **no** dividends, how would this affect the investor corporation?
   a. Result in an increased current ratio.
   b. Result in increased earnings per share.
   c. Increase several turnover ratios.
   d. Decrease book value per share.

9. What would be the most probable cause of an increase in the rate of inventory turnover while the rate of receivables turnover decreased when compared with the prior period?
   a. Sales volume has changed markedly.
   b. Investment in inventory has decreased while investment in receivables has increased.
   c. Investment in inventory has increased while investment in receivables has decreased.
   d. The corporation has shortened the credit period for customers (tightened credit terms).

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10. As generally used in accounting, what is depreciation?
   a. It is a process of asset valuation for balance-sheet purposes.
   b. It applies only to long-lived intangible assets.
   c. It is used to indicate a decline in market value of a long-lived asset.
   d. It is an accounting process which allocates long-lived asset cost to accounting periods.

11. If at the end of a period a company erroneously excluded some goods from its ending inventory and also erroneously did **not** record the purchase of these goods in its accounting records, these errors would cause
   a. The ending inventory, cost of goods available for sale, and retained earnings to be understated.
   b. The ending inventory, cost of goods sold, and retained earnings to be understated.
   c. **No** effect on net income, working capital, and retained earnings.
   d. Cost of goods available for sale, cost of goods sold, and net income to be understated.

12. The operating cycle of a business is that span of time which
   a. Coincides with the economy's business cycle which runs from one trough of the economy's business activity to the next.
   b. Corresponds with its natural business year which runs from one trough of the particular firm's business activity to the next.
   c. Is set by the industry's trade association usually on an average length of time for all firms which are members of the association.
   d. Runs from cash disbursement for items of inventory through their sale to the realization of cash from sale.

13. Which of the following is an example of an extraordinary item in reporting results of operations?
   a. A loss incurred because of a strike by employees.
   b. The write-off of deferred research and development costs believed to have no future benefit.
   c. A gain resulting from the devaluation of the U.S. dollar.
   d. A gain resulting from the state exercising its right of eminent domain on a piece of land used as a parking lot.

14. Which of the following is **not** a generally practiced method of presenting the income statement?
   a. Including prior-period adjustments in determining net income.
   b. The single-step income statement.
   c. The consolidated statement of income.
   d. Including gains and losses from discontinued operations of a segment of a business in determining net income.

15. The ABC Law Partnership showed more net income for 1973 on its cash-basis income statement than on its accrual-basis income statement. Which of the following could have caused this difference?
   a. Purchase of office supplies exceeded the usage of office supplies during 1973.
   b. Accounts receivable increased by a smaller amount than the accounts payable increased during 1973.
   c. Partners withdrew less cash from the partnership in 1973 than they withdrew in 1972.
   d. The amount of accrued payroll at the end of 1972 was larger than at the end of 1973.

16. A company has **not** paid dividends on its cumulative, nonvoting preferred stock for 20 years. Healthy earnings have been reported each year, but they have been retained to support the growth of the company. The board of directors appropriately authorized management to offer the preferred shareholders an exchange of bonds and common stock for all the preferred stock. The exchange is about to be consummated. Which of the following best describes the effect of the exchange on the company?
   a. The statute of limitations applies; hence, cumulative dividends of only seven years need to be paid on the preferred stock exchanged.
   b. The company should record an extraordinary gain for income-determination purposes to the extent that dividends in arrears do **not** have to be paid in the exchange transaction.
   c. Gain or loss should be recognized on the exchange by the company and the exchange would have to be approved by the Securities and Exchange Commission.
   d. Regardless of the market value of the bonds and common stock, **no** gain or loss should be recognized by the company on the exchange, and **no** dividends need to be paid on the preferred stock exchanged.

17. Accrued salaries payable of $5,000 were **not** recorded at December 31, 1972. Office supplies on hand of $2,000 at December 31, 1973, were erroneously treated as expense instead of supplies inventory. Neither of these errors was discovered or corrected. The effect of these two errors would cause

a. 1973 net income to be understated $7,000 and December 31, 1973, retained earnings to be understated $2,000.
b. 1972 net income and December 31, 1972, retained earnings to be understated $5,000 each.
c. 1972 net income to be overstated $5,000 and 1973 net income to be understated $2,000.
d. 1973 net income and December 31, 1973, retained earnings to be understated $2,000 each.

18. How should earned but unbilled revenues at the balance-sheet date on a long-term construction contract be disclosed if the percentage-of-completion method of revenue recognition is used?

a. As construction in progress in the current-asset section of the balance sheet.
b. As construction in progress in the noncurrent-asset section of the balance sheet.
c. As a receivable in the noncurrent-asset section of the balance sheet.
d. In a footnote to the financial statements until the customer is formally billed for the portion of work completed.

19. The estimated life of a building that has been depreciated 30 years of an originally estimated life of 50 years has been revised to a remaining life of 10 years. Based on this information and on Accounting Principles Board Opinions, the accountant should

a. Continue to depreciate the building over the original 50-year life.
b. Depreciate the remaining book value over the remaining life of the asset.
c. Adjust accumulated depreciation to its appropriate balance, through net income, based on a 40-year life and then depreciate the adjusted book value as though the estimated life had always been 40 years.
d. Adjust accumulated depreciation to its appropriate balance, through retained earnings, based on a 40-year life and then depreciate the adjusted book value as though the estimated life had always been 40 years.

Number 2 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of issues in accounting valuation concepts.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

20. A large publicly held company has developed and registered a trademark during 1973. How should the cost of developing and registering the trademark be accounted for?

a. Charged to an asset account that should **not** be amortized.
b. Expensed as incurred.
c. Amortized over 25 years if in accordance with management's evaluation.
d. Amortized over its useful life or 17 years whichever is shorter.

21. Property, plant, and equipment are conventionally presented in the balance sheet at

a. Replacement cost less accumulated depreciation.
b. Historical cost less salvage value.
c. Original cost adjusted for general price-level changes.
d. Acquisition cost less depreciated portion thereof.

22. Which of the following statements is **not** valid as it applies to inventory costing methods?

a. If inventory quantities are to be maintained, part of the earnings must be invested (plowed back) in inventories when FIFO is used during a period of rising prices.
b. LIFO tends to smooth out the net income pattern since it matches current cost of goods sold with current revenue, when inventories remain at constant quantities.
c. When a firm using the LIFO method fails to maintain its usual inventory position (reduces stock on hand below customary levels) there may be a matching of old costs with current revenue.
d. The use of FIFO permits some control by management over the amount of net income for a period through controlled purchases, which is **not** true with LIFO.

Items 23 through 26 apply to the appropriate use of present-value tables. Given below are the present-value factors for $1.00 discounted at 8% for one to five periods. Each of the following items is based on 8% interest compounded annually from day of deposit to day of withdrawal.

Periods	*Present value of $1 discounted at 8% per period*
1	0.926
2	0.857
3	0.794
4	0.735
5	0.681

23. What amount should be deposited in a bank today to grow to $1,000 three years from today?
   a. $\frac{\$1,000}{0.794}$.
   b. $1,000 x 0.926 x 3.
   c. ($1,000 x 0.926) + ($1,000 x 0.857) + ($1,000 x 0.794).
   d. $1,000 x 0.794.

24. What amount should an individual have in his bank account today before withdrawal if he needs $2,000 each year for four years with the first withdrawal to be made today and each subsequent withdrawal at one-year intervals? (He is to have exactly a zero balance in his bank account after the fourth withdrawal.)
   a. $2,000 + ($2,000 x 0.926) + ($2,000 x 0.857) + ($2,000 x 0.794).
   b. $\frac{\$2,000}{0.735} \times 4$.
   c. ($2,000 x 0.926) + ($2,000 x 0.857) + ($2,000 x 0.794) + ($2,000 x 0.735).
   d. $\frac{\$2,000}{0.926} \times 4$.

25. If an individual put $3,000 in a savings account today, what amount of cash would be available two years from today?
   a. $3,000 x 0.857.
   b. $3,000 x 0.857 x 2.
   c. $\frac{\$3,000}{0.857}$.
   d. $\frac{\$3,000}{0.926} \times 2$.

26. What is the present value today of $4,000 to be received six years from today?
   a. $4,000 x 0.926 x 6.
   b. $4,000 x 0.794 x 2.
   c. $4,000 x 0.681 x 0.926.
   d. **Cannot** be determined from the information given.

27. Which of the following statements is **not** valid in determining balance-sheet disclosure of accounts receivable?
   a. Accounts receivable should be identified on the balance sheet as "pledged" if they are used as security for a loan even though the loan is shown on the same balance sheet as a liability.
   b. That portion of installment accounts receivable from customers which falls due more than twelve months from the balance-sheet date usually would be excluded from current assets.
   c. Allowances may be deducted from the accounts receivable for discounts, returns, and adjustments to be made in the future on accounts shown in the current balance sheet.
   d. Trade receivables are best shown separately from nontrade receivables where amounts of each are material.

28. With regard to the "retail-inventory method," which of the following is the most accurate statement?
   a. Generally, accountants ignore net markups and net markdowns in computing the cost-price percentage.
   b. Generally, accountants include both net markups and net markdowns in computing the cost-price percentage.
   c. This method results in a lower ending-inventory cost if net markups are included but net markdowns are excluded in computing the cost-price percentage.
   d. It is **not** adaptable to LIFO costing.

29. When using one of the discounted-cash-flow methods to evaluate the desirability of a capital-budgeting project, which of the following factors generally is **not** important?
   a. The method of financing the project under consideration.
   b. The timing of cash flows relating to the project.
   c. The impact of the project on income taxes to be paid.
   d. The amount of cash flows relating to the project.

30. Dekovan Equipment Company acquired a three-acre site for the construction of a new branch plant. Which of the following costs (or groups of costs) should **not** be charged to the land account of the company?
   a. Title examination fees, recording fees, and surveying fees.
   b. Costs for grading, clearing, and draining the property.
   c. Costs of removing an old, unwanted building from the land.
   d. Property taxes accruing during the period of plant construction.

31. Unearned discounts, finance charges, and unearned interest included in the face amount of notes receivable should be reported on the financial statements as
   a. A deduction from the related receivables.
   b. Deferred credits.
   c. Deferred charges.
   d. An appropriation of retained earnings.

32. What would be the effect on the financial statements if an unconsolidated subsidiary is accounted for by the equity method, but consolidated statements are being prepared with other subsidiaries?
   a. All of the unconsolidated subsidiary's accounts will be included individually in the consolidated statements.
   b. The consolidated retained earnings will **not** reflect the earnings of the unconsolidated subsidiary.
   c. The consolidated retained earnings will be the same as if the subsidiary had been included in the consolidation.
   d. Dividend revenue from the unconsolidated subsidiary will be reflected in consolidated net income.

33. If a parent company bills all sales to a foreign subsidiary in terms of dollars and is to be repaid in the same number of dollars, the purchases account on the subsidiary's trial balance will be converted to U.S. dollars by using
   a. The average exchange rate for the period.
   b. The exchange rate at the beginning of the period.
   c. The exchange rate at the end of the period.
   d. The amount showing in the parent's accounts for sales to the subsidiary.

34. Which of the following is **not** an acceptable basis for valuation of certain inventories in published financial statements?
   a. Historical cost.
   b. Current replacement cost.
   c. Prime cost.
   d. Current selling price, less cost of disposal.

35. The effectiveness of the net present-value method has been questioned as an evaluation technique for capital-budgeting decisions on the basis that
   a. Predicting future cash flows is often difficult and clouded with uncertainties.
   b. The accounting rate-of-return method is usually more accurate and useful.
   c. The payback technique is theoretically more reliable.
   d. The computation involves some difficult mathematical applications that most accountants **cannot** perform.

36. The four measurement bases currently used in financial accounting for asset measurement do **not** include the
   a. Amount of cash expected to be received in the future, as in the normal conversion of an account receivable.
   b. Price in a current purchase, as in applying lower of cost or market to inventories.
   c. Price in a current sale, as in applying lower of cost or market to temporary investments.
   d. Price of a past purchase adjusted for changes in the general purchasing power of the dollar, as in the application of the LIFO inventory method.

37. How is the portion of consolidated earnings to be assigned to minority interest in consolidated financial statements determined?
   a. The net income of the parent is subtracted from the subsidiary's net income to determine the minority interest.
   b. The subsidiary's net income is extended to the minority interest.
   c. The amount of the subsidiary's earnings recognized for consolidation purposes is multiplied by the minority's percentage ownership.
   d. The amount of consolidated earnings determined on the consolidated working papers is multiplied by the minority interest percentage at the balance-sheet date.

38. Lochlann Company purchased with United States dollars all the outstanding common stock of Dey Company, a Canadian corporation. At the date of purchase, a portion of the investment account was appropriately allocated to goodwill. One year later, after an exchange rate decrease (U.S. dollars have become less valuable), the goodwill should be shown in the consolidated balance sheet at what amount?
   a. An increased amount, less amortization.
   b. The same amount, less amortization.
   c. A lesser amount, less amortization.
   d. An increased or lesser amount depending on management policy, less amortization.

Number 3 (Estimated time –– 25 to 30 minutes)

Hawkes Systems, Inc., a chemical processing company, has been operating profitably for many years. On March 1, 1974, Hawkes purchased 50,000 shares of Diversified Insurance Company stock for $2,000,000. The 50,000 shares represented 25% of Diversified's outstanding stock. Both Hawkes and Diversified operate on a fiscal year ending August 31.

For the fiscal year ended August 31, 1974, Diversified reported net income of $800,000 earned ratably throughout the year. During November, 1973, February, May, and August, 1974, Diversified paid its regular quarterly cash dividend of $100,000.

Required:

a. What criteria should Hawkes consider in determining whether its investment in Diversified should be classified as (1) a current asset (marketable security) or (2) a noncurrent asset (investment) in Hawkes' August 31, 1974, balance sheet? Confine your discussion to the decision criteria for determining the balance-sheet classification of the investment.

b. Assume that the investment should be classified as a long-term investment in the noncurrent-asset section of Hawkes' balance sheet. The cost of Hawkes' investment equaled its equity in the recorded values of Diversified's net assets; recorded values were not materially different from fair values (individually or collectively). For the fiscal year ended August 31, 1974, how did the net income reported and dividends paid by Diversified affect the accounts of Hawkes (including Hawkes' income tax accounts)? Indicate each account affected, whether it increased or decreased, and explain the reason for the change in the account balance (such as Cash, Investment in Diversified, etc.). Organize your answer in the following format.

Account Name	*Increase or Decrease*	*Reason for Change in Account Balance*

c. Independent of your answer to part **a.** and **b.** above, assume Hawkes had purchased 70% of Diversified's stock on March 1, 1974.

1. Under certain circumstances Hawkes (the parent) should not accrue income taxes on all or part of its equity in the undistributed earnings of Diversified (its subsidiary). What are these circumstances and what evidence and other considerations must be evaluated to substantiate these circumstances?
2. What information should be disclosed in the notes to its financial statements if Hawkes does not accrue income taxes on all or part of its equity in the undistributed earnings of Diversified?
3. Would it be appropriate to prepare consolidated financial statements for Hawkes and its subsidiary, Diversified, for the fiscal year ended August 31, 1974? Explain.

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

Part a. The earning of revenue by a business enterprise is recognized for accounting purposes when the transaction is recorded. In some situations, revenue is recognized approximately as it is earned in the economic sense. In other situations, however, accountants have developed guidelines for recognizing revenue by other criteria; such as, at the point of sale.

Required (ignore income taxes):

1. Explain and justify why revenue is often recognized as earned at time of sale.
2. Explain in what situations it would be appropriate to recognize revenue as the productive activity takes place.
3. At what times, other than those included in 1. and 2. above, may it be appropriate to recognize revenue? Explain.

Part b. Income measurement can be divided into different income concepts classified by income recipients. The following income concepts are tailored to the listed categories of income recipients.

Income Concepts	*Income Recipients*
1. Net income to residual equity holders.	Common stockholders.
2. Net income to investors.	Stockholders and long-term debt holders.
3. Value-added income.	All employees, stockholders, governments, and some creditors.

Required:

For each of the concepts listed above, explain in separately numbered paragraphs what major categories of revenue, expense, and other items would be included in the determination of income.

Number 5 (Estimated time — 25 to 30 minutes)

Nubo Manufacturing, Inc., is presently operating at 50% of practical capacity producing about 50,000 units annually of a patented electronic component. Nubo recently received an offer from a company in Yokohama, Japan, to purchase 30,000 components at $6.00 per unit, FOB Nubo's plant. Nubo has not previously sold components in Japan. Budgeted production costs for 50,000 and 80,000 units of output follow:

Units	50,000	80,000
Costs:		
Direct material	$ 75,000	$120,000
Direct labor	75,000	120,000
Factory overhead	200,000	260,000
Total costs	$350,000	$500,000
Cost per unit	$7.00	$6.25

The sales manager thinks the order should be accepted, even if it results in a loss of $1.00 per unit, because he feels the sales may build up future markets. The production manager does not wish to have the order accepted primarily because the order would show a loss of $.25 per unit when computed on the new average unit cost. The treasurer has made a quick computation indicating that accepting the order will actually increase gross margin.

Required:

a. Explain what apparently caused the drop in cost from $7.00 per unit to $6.25 per unit when budgeted production increased from 50,000 to 80,000 units. Show supporting computations.

b. 1. Explain whether (either or both) the production manager or the treasurer is correct in his reasoning.

2. Explain why the conclusions of the production manager and the treasurer differ.

c. Explain why each of the following may affect the decision to accept or reject the special order.

1. The likelihood of repeat special sales and/or all sales to be made at $6.00 per unit.
2. Whether the sales are made to customers operating in two separate, isolated markets or whether the sales are made to customers competing in the same market.

Number 6 (Estimated time — 25 to 30 minutes)

Part a. Standard costs are being used increasingly by modern manufacturing companies. Many advocates of standard costing take the position that standard costs are a proper basis for inventory valuation for external reporting purposes. Accounting Research Bulletin No. 43, however, reflects the widespread view that standard costs are not acceptable unless "adjusted at reasonable intervals to reflect current conditions so that at the balance-sheet date standard costs reasonably approximate costs computed under one of the recognized (actual cost) bases."

Required:

1. Discuss the conceptual merits of using standard costs as the basis for inventory valuation for external reporting purposes.
2. Prepare general-journal entries for three alternative dispositions of a $1,500 unfavorable variance where all goods manufactured during the period are included in the ending finished-goods inventory. Assume a formal standard-cost system is in operation, that $500 of the variance resulted from actual costs exceeding attainable standard cost, and that $1,000 of the variance resulted from the difference between the "ideal standard" and an attainable standard.
3. Discuss the conceptual merits of each of the three alternative methods of disposition requested in 2. above.

Part b. Strayer Company, which uses a fully integrated standard-cost system, had budgeted the following sales and costs for 1973:

Unit sales	20,000
Sales	$200,000
Total production costs at standard cost	130,000
Gross margin	70,000
Beginning inventories	None
Ending inventories	None

At the end of 1973 Strayer Company reported production and sales of 19,200 units. Total factory overhead incurred was exactly equal to budgeted factory overhead for 1973 and there was underapplied total factory overhead of $2,000 at December 31, 1973. Factory overhead is applied to the work-in-process inventory on the basis of standard direct labor hours allowed for units produced. Also, there was a favorable direct labor efficiency variance, but no direct labor rate variance and no raw-material variances for 1973.

Required:

Explain why factory overhead was underapplied by \$2,000, and being as specific as the data permit, indicate which overhead variances may have been affected. Strayer uses a three variance method of analyzing the total factory overhead variance; the three variances are (1) spending variance, (2) efficiency variance, and (3) volume variance.

Number 7 (Estimated time –– 25 to 30 minutes)

Raun Company had the following account titles on its December 31, 1973, trial balance:

6% cumulative convertible preferred stock, \$100 par value
Premium on preferred stock
Common stock, \$1 stated value
Premium on common stock
Retained earnings

The following additional information about the Raun Company was available for the year ended December 31, 1973:

- There were 2,000,000 shares of preferred stock authorized of which 1,000,000 were outstanding. All 1,000,000 shares outstanding were issued on January 2, 1970, for \$120 a share. The bank prime interest rate was 8.5% on January 2, 1970, and was 10% on December 31, 1973. The preferred stock is convertible into common stock on a one-for-one basis until December 31, 1979; thereafter the preferred stock ceases to be convertible and is callable at par value by the company. No preferred stock has been converted into common stock, and there were no dividends in arrears at December 31, 1973.

- The common stock has been issued at amounts above stated value per share since incorporation in 1955. Of the 5,000,000 shares authorized, there were 3,500,000 shares outstanding at January 1, 1973. The market price of the outstanding common stock has increased slowly, but consistently, for the last five years.

- The company has an employee stock option plan where certain key employees and officers may purchase shares of common stock at 100% of the market price at the date of the option grant. All options are exercisable in installments of one-third each year, commencing one year after the date of the grant, and expire if not exercised within four years of the grant date. On January 1, 1973, options for 70,000 shares were outstanding at prices ranging from \$47.00 to \$83.00 a share. Options for 20,000 shares were exercised at \$47.00 to \$79.00 a share during 1973. No options expired during 1973 and additional options for 15,000 shares were granted at \$86.00 a share during the year. The 65,000 options outstanding at December 31, 1973, were exercisable at \$54.00 to \$86.00 a share; of these, 30,000 were exercisable at that date at prices ranging from \$54.00 to \$79.00 a share.

- The company also has an employee stock purchase plan where the company pays one-half and the employee pays one-half of the market price of the stock at the date of the subscription. During 1973, employees subscribed to 60,000 shares at an average price of \$87.00 a share. All 60,000 shares were paid for and issued late in September 1973.

- On December 31, 1973, there was a total of 355,000 shares of common stock set aside for the granting of future stock options and for future purchases under the employee stock purchase plan. The only changes in the stockholders' equity for 1973 were those described above, 1973 net income, and cash dividends paid.

Required:

a. Prepare the stockholders' equity section of the balance sheet of Raun Company at December 31, 1973; substitute, where appropriate, Xs for unknown dollar amounts. Use good form and provide full disclosure. Write appropriate footnotes as they should appear in the published financial statements.

b. Explain how the amount of the denominator should be determined to compute **primary** earnings per share for presentation in the financial statements. Be specific as to the handling of each item. If additional information is needed to determine whether an item should be included or excluded or the extent to which an item should be included, identify the information needed and how the item would be handled if the information were known. Assume Raun Company had substantial net income for the year ended December 31, 1973.

Uniform Certified Public Accountant Examination

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING PRACTICE — PART I

May 7, 1975; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	40	50
No. 2	40	50
No. 3	50	60
No. 4	50	60
No. 5	40	50
Total	220	270

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, number the pages in sequence for that question with the lead schedule first, followed by supporting computations. For instance, if you use three pages for Question No. 3, you should show Question 3, Page 1 of 3, Page 2 of 3, and Page 3 of 3. The printed answer sheet provided for the objective-type items should be considered to be Page 1.
2. **Enclose all scratch sheets.** Failure to enclose scratch sheets may result in loss of grading points. Scratch sheets need not have page numbers, but you should show the question number and place them immediately following the question to which they relate.
3. Fourteen-column sheets should not be folded until all sheets, both wide and narrow, are placed in the proper sequence and fastened together at the top left corner. All fourteen-column sheets should then be wrapped around the back of the papers.
4. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 40 to 50 minutes)

Instructions

• Select the **best** answer for each of the following items relating to **a variety of financial-accounting problems.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to $5,260,000; sales returns and allowances reduced the amounts owed by $160,000. How much were net sales last year for Baker Company?

a. $4,800,000.
b. $5,100,000.
c. $5,200,000.
d. $5,260,000.

Answer Sheet

97. a. :::::::::: b. ▬▬▬ c. :::::::::: d. ::::::::::

Items to be Answered

Items 1 and 2 are based on the following information:

• On July 1, 1974, Miller Mining, a calendar-year corporation, purchased the rights to a copper mine. Of the total purchase price, $2,800,000 was appropriately allocable to the copper. Estimated reserves were 800,000 tons of copper. Miller expects to extract and sell 10,000 tons of copper per month. Production began immediately. The selling price is $25 per ton. Miller uses percentage depletion (15%) for tax purposes.

To aid production, Miller also purchased some new equipment on July 1, 1974. The equipment cost $76,000 and had an estimated useful life of eight years. However, after all the copper is removed from this mine, the equipment will be of **no** use to Miller and will be sold for an estimated $4,000.

1. If sales and production conform to expectations, what is Miller's depletion expense on this mine for financial-accounting purposes for the calendar year 1974?

a. $105,000.
b. $210,000.
c. $225,000.
d. $420,000.

2. If sales and production conform to expectations, what is Miller's depreciation expense on the new equipment for financial-accounting purposes for the calendar year 1974?

a. $4,500.
b. $5,400.
c. $9,000.
d. $10,800.

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3. Willard, Inc., had purchased some equipment on January 2, 1971, for $24,000 (**no** salvage). Willard used straight-line depreciation based on a ten-year estimated life. During 1974, Willard decided that this equipment would be used only three more years and then replaced with a technologically superior model. What entry, if any, should Willard make as of January 1, 1974, to reflect this change?

a. **No** entry.
b. Debit a special "retroactive adjustment" account for $4,800 and credit accumulated depreciation for $4,800.
c. Debit retained earnings as a prior-period adjustment for $4,800 and credit accumulated depreciation for $4,800.
d. Debit depreciation expense for $4,800 and credit accumulated depreciation for $4,800.

4. Belfin Company estimates its annual warranty expense as 2% of annual net sales. The following data relate to the calendar year 1974:

Net sales	$3,200,000	
Warranty liability account:		
Balance, December 31, 1974		10,000 debit **before** adjustment
Balance, December 31, 1974		54,000 credit **after** adjustment

Which one of the following entries was made to record the 1974 estimated warranty expense?

		Debit	*Credit*
a.	Warranty expense	$64,000	
	Retained earnings (prior-period adjustment)		$10,000
	Warranty liability		54,000
b.	Warranty expense	54,000	
	Retained earnings (prior-period adjustment)	10,000	
	Warranty liability		64,000
c.	Warranty expense	44,000	
	Warranty liability		44,000
d.	Warranty expense	64,000	
	Warranty liability		64,000

5. Gorch Company sold some machinery which was **not** merchandise. Gorch received a noninterest-bearing note to be paid $1,000 per year for 10 years. A fair rate of interest for this transaction is 8%. The present value of $1.00 at 8% after 10 periods is $.463. The present value of an annuity in arrears of $1.00 at 8% for 10 periods is $6.710. What discount should Gorch record on this transaction?
   a. Zero.
   b. $3,290.
   c. $4,630.
   d. $6,710.

6. For 1974, cost of goods available for sale for Red Corporation was $400,000. The gross margin was 25% of sales. Sales for the year were $480,000. What was the amount of the ending inventory?
   a. $20,000.
   b. $40,000.
   c. $60,000.
   d. $80,000.

7. The Topper Department Store uses the retail-inventory method to approximate cost. For Department 302 for January 1975 cost of goods available for sale was $60,000 at cost and $75,000 at retail before considering net markups of $5,000 and net markdowns of $8,000. If sales were $66,000, how much was the inventory approximating lower of cost or market at the end of January 1975?
   a. $4,500.
   b. $4,800.
   c. $5,000.
   d. $6,000.

8. Roaster Company issued bonds with detachable stock warrants. Each warrant granted an option to buy one share of $40 par value common stock for $75 per share. Five hundred warrants were originally issued, and $4,000 was appropriately credited to "warrants." If 90% of these warrants are exercised when the market price of the common stock is $85 per share, how much should be credited to "capital in excess of par" on this transaction?
   a. $19,350.
   b. $19,750.
   c. $23,850.
   d. $24,250.

9. Arthur Plack, a partner in the Brite Partnership, has a 30% participation in partnership profits and losses. Plack's capital account had a net decrease of $60,000 during the calendar year 1974. During 1974, Plack withdrew $130,000 (charged against his capital account) and contributed property valued at $25,000 to the partnership. What was the net income of the Brite Partnership for 1974?
   a. $150,000.
   b. $233,333.
   c. $350,000.
   d. $550,000.

10. Partners Allen, Baker, and Coe share profits and losses 50:30:20, respectively. The balance sheet at April 30, 1975, follows:

Assets:	
Cash	$ 40,000
Other assets	360,000
	$400,000
Liabilities and Capital:	
Accounts payable	$100,000
Allen, Capital	74,000
Baker, Capital	130,000
Coe, Capital	96,000
	$400,000

The assets and liabilities are recorded and presented at their respective fair values.

Jones is to be admitted as a new partner with a 20% capital interest and a 20% share of profits and losses in exchange for a cash contribution. **No** goodwill or bonus is to be recorded. How much cash should Jones contribute?
   a. $60,000.
   b. $72,000.
   c. $75,000.
   d. $80,000.

11. Geller and Harden formed a partnership on January 2, 1974, and agreed to share profits 90%, 10%, respectively. Geller contributed capital of $25,000. Harden contributed **no** capital but has a specialized expertise and manages the firm full time. There were **no** withdrawals during the year. The partnership agreement provides for the following:

- Capital accounts are to be credited annually with interest at 5% of beginning capital.
- Harden is to be paid a salary of $1,000 a month.
- Harden is to receive a bonus of 20% of income calculated before deducting his salary and interest on both capital accounts.
- Bonus, interest, and Harden's salary are to be considered partnership expenses.

The partnership 1974 income statement follows:

Revenues	$96,450
Expenses (including salary, interest, and bonus)	49,700
Net income	$46,750

What is Harden's 1974 bonus?
   a. $11,688.
   b. $12,000.
   c. $15,000.
   d. $15,738.

12. Blacker Company exchanged a business automobile for a new automobile. The old automobile had an original cost of $3,500, an undepreciated cost of $1,600, and a market value of $2,000 when exchanged. In addition, Blacker paid $2,200 cash for the new automobile. The list price of the new automobile was $4,300. At what amount should the new automobile be recorded for financial-accounting purposes?
   a. $3,500.
   b. $3,800.
   c. $4,200.
   d. $4,300.

Items 13 and 14 are based on the following information:

In 1974, Long Corporation began construction work under a three-year contract. The contract price is $800,000. Long uses the percentage-of-cost-completion method for financial-accounting purposes. The income to be recognized each year is based on the proportion of cost incurred to total estimated costs for completing the contract. The financial-statement presentations relating to this contract at December 31, 1974, follow:

Balance Sheet

Accounts receivable – construction contract billings		$15,000
Construction in progress	$50,000	
Less contract billings	47,000	
Cost of uncompleted contract in excess of billings		3,000

Income Statement

Income (before tax) on the contract recognized in 1974	$10,000

13. How much cash was collected in 1974 on this contract?
   a. $15,000.
   b. $32,000.
   c. $35,000.
   d. $47,000.

14. What was the initial estimated total income before tax on this contract?
   a. $10,000.
   b. $30,000.
   c. $160,000.
   d. $200,000.

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15. Nolan Co. began operations in 1970. It had been computing depreciation by an accelerated method until January 1, 1974, when a change to the straight-line method was made. Assume the change is justified.

Depreciation computed by the accelerated method was reported as follows:

1970	*1971*	*1972*	*1973*
$9,000	$8,000	$8,000	$7,000

Had the straight-line method been used, depreciation would have been as follows:

1970	*1971*	*1972*	*1973*
$5,200	$5,200	$5,800	$5,800

The change to straight-line depreciation is effective January 1, 1974, and the new method will be applied both to assets acquired prior to that date and to those subsequently acquired.

Nolan's income tax rate has been 40% throughout the years 1970-1973.

Nolan's 1974 income before taxes and before the cumulative effect of the accounting change is $50,000. What is Nolan's 1974 net income?
   a. $16,000.
   b. $24,000.
   c. $36,000.
   d. $60,000.

16. Trail, Inc., has a current ratio of .65 to 1. A cash dividend declared last month is paid this month. What is the effect of this dividend payment on the current ratio and working capital, respectively?
   a. Rise and decline.
   b. Rise and **no** effect.
   c. Decline and **no** effect.
   d. **No** effect on either.

17. Pat Company had bonds outstanding with a maturity value of $100,000. On April 30, 1975, when these bonds had an unamortized discount of $4,000, they were called in at 106. To pay for these bonds, Pat had issued other bonds a month earlier bearing a lower interest rate. The newly issued bonds had a life of ten years. The new bonds were issued at 102 (face value $100,000). Issue costs related to the new bonds were $3,000. Ignoring interest what amount should Pat show as a 1975 ordinary loss on this refunding for financial-accounting purposes?
   a. Zero.
   b. $1,000.
   c. $1,300.
   d. $10,000.

Number 2 (Estimated time -- 40 to 50 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of managerial-accounting and quantitative-methods problems.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

Items 18, 19, and 20 are based on the following information:

The following information relates to a given department of Herman Company for the fourth quarter 1974:

Actual total overhead (fixed plus variable)	$178,500
Budget formula	$110,000 plus $0.50 per hour
Total overhead application rate	$1.50 per hour
Spending variance	$8,000 unfavorable
Volume variance	$5,000 favorable

The total overhead variance is divided into three variances – spending, efficiency, and volume.

18. What were the actual hours worked in this department during the quarter?
   a. 110,000.
   b. 121,000.
   c. 137,000.
   d. 153,000.

19. What were the standard hours allowed for good output in this department during the quarter?
   a. 105,000.
   b. 106,667.
   c. 110,000.
   d. 115,000.

20. Each unit takes five hours to manufacture, and the selling price is $4.50 per unit. Based on the overhead budget formula, how many units must be sold to generate $30,000 more than total budgeted overhead costs?
   a. 27,500.
   b. 35,000.
   c. 55,000.
   d. 70,000.

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21. A business has analyzed a proposed investment in depreciable assets using the net present-value method. The analysis assumed the use of straight-line depreciation for tax purposes. If the assumption is changed to accelerated depreciation for tax purposes, the analysis will be redone. Which of the following statements **best** describes the effect of the change from straight-line to accelerated depreciation on the new analysis of the proposed investment?
   a. The risk of the proposed investment will be larger than if straight-line depreciation is used.
   b. The results will be invalid because accelerated depreciation **cannot** be used for tax purposes.
   c. The cash flows in each period after income-tax effects will be smaller than if straight-line depreciation is used.
   d. The net present value of the proposed investment will be larger than if straight-line depreciation is used.

22. Net profit under absorption costing may differ from net profit determined under direct costing. How is this difference calculated?
   a. Change in the quantity of all units in inventory times the relevant fixed cost per unit.
   b. Change in the quantity of all units produced times the relevant fixed cost per unit.
   c. Change in the quantity of all units in inventory times the relevant variable cost per unit.
   d. Change in the quantity of all units produced times the relevant variable cost per unit.

23. Assuming that demand is deterministic, what is the essence of the economic order quantity (EOQ) model for inventory?
   a. To minimize order costs or carrying costs and maximize the rate of inventory turnover.
   b. To minimize order costs or carrying costs whichever are higher.
   c. To order sufficient quantity to economically meet the next period's demand.
   d. To minimize the total of order costs and carrying costs.

24. The Carlo Company budgeted overhead at $255,000 for the period for Department A based on a budgeted volume of 100,000 direct-labor hours. At the end of the period the factory-overhead control account for Department A had a balance of $270,000; actual direct-labor hours were 105,000.

What was the overapplied (underapplied) overhead for the period?
   a. $2,250.
   b. $(2,250).
   c. $15,000.
   d. $(15,000).

Items 25 through 28 are based on the following information:

The Apex Company is evaluating a capital-budgeting proposal for the current year. The relevant data follow:

Year	*Present Value of an Annuity in Arrears of $1 at 15%*
1	$ .870
2	1.626
3	2.284
4	2.856
5	3.353
6	3.785

The initial investment would be $30,000. It would be depreciated on a straight-line basis over six years with **no** salvage. The before-tax annual cash inflow due to this investment is $10,000, and the income tax rate is 40% paid the same year as incurred. The desired rate of return is 15%. All cash flows occur at year end.

25. What is the after-tax accounting rate of return on Apex's capital-budgeting proposal?
    a. 10%.
    b. 16-2/3%.
    c. 26-2/3%.
    d. 33-1/3%.

26. What is the after-tax payback reciprocal for Apex's capital-budgeting proposal?
    a. 20%.
    b. 26-2/3%.
    c. 33-1/3%.
    d. 50%.

27. What is the net present value of Apex's capital-budgeting proposal?
    a. $(7,290).
    b. $280.
    c. $7,850.
    d. $11,760.

28. How much would Apex have had to invest five years ago at 15% compounded annually to have $30,000 now?
    a. $12,960.
    b. $14,910.
    c. $17,160.
    d. **Cannot** be determined from the information given.

Items 29, 30, and 31 are based on the following information:

The Random Company manufactures two products, Zeta and Beta. Each product must pass through two processing operations. All materials are introduced at the start of Process No. 1. There are **no** work-in-process inventories. Random may produce either one product exclusively or various combinations of both products subject to the following constraints:

	Process No. 1	*Process No. 2*	*Contribution Margin Per Unit*
Hours required to produce one unit of:			
Zeta	1 hour	1 hour	$4.00
Beta	2 hours	3 hours	5.25
Total capacity in hours per day	1,000 hours	1,275 hours	

A shortage of technical labor has limited Beta production to 400 units per day. There are **no** constraints on the production of Zeta other than the hour constraints in the above schedule. Assume that all relationships between capacity and production are linear, and that all of the above data and relationships are deterministic rather than probabilistic.

29. Given the objective to maximize total contribution margin, what is the production constraint for Process No. 1?
    a. Zeta + Beta $\leqslant$ 1,000.
    b. Zeta + 2Beta $\leqslant$ 1,000.
    c. Zeta + Beta $\geqslant$ 1,000.
    d. Zeta + 2Beta $\geqslant$ 1,000.

30. Given the objective to maximize total contribution margin, what is the labor constraint for production of Beta?
    a. Beta $\leqslant$ 400.
    b. Beta $\geqslant$ 400.
    c. Beta $\leqslant$ 425.
    d. Beta $\geqslant$ 425.

31. What is the objective function of the data presented?
    a. Zeta + 2Beta = \$9.25.
    b. \$4.00 Zeta + 3(\$5.25) Beta = Total Contribution Margin.
    c. \$4.00 Zeta + \$5.25 Beta = Total Contribution Margin.
    d. 2(\$4.00) Zeta + 3(\$5.25) Beta = Total Contribution Margin.

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32. The Caprice Company has four transport trucks with costs as follows: Truck A, \$37,000; Truck B, \$14,000; Truck C, \$20,000; and Truck D, \$30,000. The useful life of each truck is five years, and the company will use the sum-of-the-years'-digits depreciation method. The salvage value is 15% for Trucks A, B, and C and 10% for Truck D.

The matrix representations for these depreciation calculations are partially represented below.

$$\underline{I} \quad \begin{bmatrix} T & 0.0 & 0.0 & 0.0 \\ 0.0 & U & 0.0 & 0.0 \\ 0.0 & 0.0 & V & 0.0 \\ 0.0 & 0.0 & 0.0 & W \end{bmatrix} \qquad \underline{C} \quad \begin{bmatrix} H \\ J \\ K \\ 30{,}000 \end{bmatrix}$$

$$\underline{R} \quad [1/3 \quad 4/15 \quad 1/5 \quad 2/15 \quad 1/15]$$

Which of the following notations represents the calculation of depreciation for the second year for Truck C?
    a. T x J x 4/15.
    b. V x J x 1/5.
    c. W x K x 1/5.
    d. V x K x 4/15.

33. Which one of the following is true concerning standard costs?
    a. Standard costs are estimates of costs attainable only under the most ideal conditions, but rarely practicable.
    b. Standard costs are difficult to use with a process-costing system.
    c. If properly used, standards can help motivate employees.
    d. Unfavorable variances, material in amount, should be investigated, but large favorable variances need **not** be investigated.

34. The Stat Company wants more information on the demand for its products. The following data are relevant:

Units Demanded	*Probability of Unit Demand*	*Total Cost of Units Demanded*
0	.10	\$ 0
1	.15	1.00
2	.20	2.00
3	.40	3.00
4	.10	4.00
5	.05	5.00

What is the total expected value or payoff with perfect information?
    a. \$2.40.
    b. \$7.40.
    c. \$9.00.
    d. \$9.15.

Number 3 (Estimated time — 50 to 60 minutes)

During the course of your examination of the financial statements of Craig Corporation for the year ended December 31, 1974, you found a new account, "Investments." Your examination revealed that during 1974, Craig began a program of investments, and all investment-related transactions were entered in this account. Your analysis of this account for 1974 follows:

Craig Corporation
ANALYSIS OF INVESTMENTS
For the year ended December 31, 1974

Date 1974		*Debit*	*Credit*
	(a) *Ace Tool Company Common Stock*		
March 15	Purchased 1,000 shares @ $25 per share.	$ 25,000	
June 28	Received 50 shares of Bymore Sales Company common stock as a dividend on Ace Tool Company common stock (Memorandum entry in general ledger).		
September 30	Sold 50 shares of Bymore Sales Company common stock @ $14 per share.		$ 700
October 31	Awarded 500 shares of Ace Tool Company common stock to selected members of Craig's management as an incentive award and accounted for as employee compensation.		12,500
	(b) *Mascot, Inc., Common and Preferred Stock*		
March 15	Purchased 600 units of common and preferred stock @ $36 per unit. Each unit consists of one share of preferred and two shares of common stock.	21,600	
April 30	Sold 300 shares of common stock @ $13 per share.		3,900
June 28	Received 900 common stock rights. Each right entitles the holder to purchase one share of common stock for $12 (Memorandum entry in general ledger).		
September 30	Exercised 450 common stock rights to acquire 450 shares of common stock @ $12 per share.	5,400	
September 30	Sold remaining 450 common stock rights @ $4 per right.		1,800
	(c) *Standard Service, Inc., Common Stock*		
March 15	Purchased 10,000 shares @ $17 per share.	170,000	
October 31	Received dividend of $.75 per share.		7,500
	(d) *Azuma Mines, Inc., Convertible Bonds (Due September 30, 1983, with interest at 7% payable March 31 and September 30)*		
April 30	Purchased forty $1,000 bonds @ 100 plus accrued interest.	40,233	
September 30	Received interest due.		1,400
September 30	Converted ten bonds into 200 shares of Azuma Mines common stock.		10,000
September 30	Received 200 shares of common stock on conversion of bonds.	10,000	
October 31	Sold the remaining thirty bonds @ 102 plus interest for one month. The interest was credited to interest revenue.		30,600

(e)
Kevin Instruments, Inc., Common Stock

March 15	Purchased 4,000 shares @ $28 per share.	$112,000	
April 30	Purchased 2,000 shares @ $30 per share.	60,000	
June 28	Received dividend of $.40 per share.		$ 2,400

(f)
Other Investment

October 31	Reacquired 1,600 shares of its own (Craig) outstanding common stock @ $14 per share with the intention of retiring them.	22,400

Additional information:

1. The fair market values for each security as of the 1974 date of each transaction follow:

Security	*March 15*	*April 30*	*June 28*	*September 30*	*October 31*
Ace Tool Company Common Stock	25				42
Bymore Sales Company Common Stock			8	14	
Mascot, Inc., Preferred Stock	20				
Mascot, Inc., Common Stock	10	13	15*	16	
Mascot, Inc., Common Stock Rights			3	4	
Standard Service, Inc., Common Stock	17				
Azuma Mines, Inc., Bonds		100		100	102
Azuma Mines, Inc., Common Stock				65	
Kevin Instruments, Inc., Common Stock	28	30			
Craig Corporation, Common Stock					14

*Ex-rights

2. Assume that in accordance with Craig's practice, **no** gain was recognized on conversion of the Azuma convertible bonds into Azuma common stock.
3. Standard Service, Inc., has only one class of stock authorized and there were 30,000 shares of its common stock outstanding throughout 1974. Craig's cost of its investment in Standard was **not** materially different from its equity in the recorded values of Standard's net assets; recorded values were **not** materially different from fair values (individually or collectively). Standard's net income from the date of acquisition of Craig's investment to December 31, 1974, was $336,000. There were **no** intercompany transactions requiring elimination.
4. Kevin Instruments, Inc., has only one class of stock authorized and there were 40,000 shares of its common stock outstanding throughout 1974. Craig's cost of its investment in Kevin was **not** materially different from its equity in the recorded values of Kevin's net assets; recorded values were **not** materially different from fair values (individually or collectively). Kevin's net income from the date of acquisition of Craig's investment to December 31, 1974, was $120,000. There were **no** intercompany transactions requiring elimination.
5. All other investments of Craig are widely held, and Craig's percentage of ownership in each is nominal (5% or less).
6. At December 31, 1974, Craig Corporation had 98,400 shares of its $10 par value common stock outstanding. The balance in the "Premium on Common Stock" account was $100,000.

Required:

Prepare necessary adjusting journal entries classified by each of the securities analyzed in (a) through (f) to properly adjust the "Investments" account. Identify each security by type (preferred stock, common stock, rights, etc.) as well as by company. Schedules supporting calculations should be in good form and either included as part of the journal entry explanation or properly cross-referenced to the appropriate journal entry. **Ignore brokers' fees, transfer and income taxes.**

Number 4 (Estimated time — 50 to 60 minutes)

This question concerns the various interrelationships among financial statements, accounts (or groups of accounts) among those statements, and accounts (or groups of accounts) within each statement. The following information is presented for Woods Company for the year ended December 31, 1974:

- The Statement of Changes in Financial Position.
- Selected information from the Income Statement.
- Selected information regarding the January 1 and December 31 Balance Sheets.
- Information regarding the correction of an error.
- Partially completed Balance Sheets at January 1 (prior to restatement) and December 31. The omitted account and groups-of-account balances are numbered from (1) through (16) and can be calculated from the other information given.

Statement of Changes in Financial Position

Working capital, January 1, 1974		$16,500
Add resources provided:		
Operations:		
Net loss for 1974	$(2,885)	
Adjustments not involving working capital:		
Bond premium amortization	(500)	
Deferred income taxes	(200)	
Depreciation expense	3,000	
Goodwill amortization for 1974	2,000	
Total from operations	1,415	
Portion of proceeds of equipment sold representing undepreciated cost	10,000	
Proceeds from reissue of treasury stock	11,400	
Par value of common stock issued to reacquire preferred stock	7,500	
Total resources provided	30,315	
Subtract resources applied:		
Purchase of land	14,715	
Current maturity of long-term bond debt	7,200	
Par value of preferred stock reacquired by issuing common stock	7,500	
Total resources applied	29,415	
Increase in working capital		900
Working capital, December 31, 1974		$17,400

Information from the Income Statement

Bad debt expense		$750
Bond interest expense (net of amortization of bond premium)		$3,500
Loss before tax adjustment		$(3,900)
Less:		
Income tax adjustment (refund due)	$815	
Deferred income taxes	200	1,015
Net loss after tax adjustment		$(2,885)

Information Regarding January 1 and December 31 Balance Sheets

The book value of the equipment sold was two-thirds of the cost of that equipment.

Selected Ratios

	January 1, 1974 (prior to restatement)	December 31, 1974
Current ratio	?	3 to 1
Total stockholders' equity divided by total liabilities	4 to 3	?

Information Regarding the Correction of an Error

Woods Company had neglected to amortize $2,000 of goodwill in 1973. The correction of this material error has been appropriately made in 1974.

	Balance Sheet	
	January 1, 1974 (prior to restatement)	*December 31, 1974*
Current assets	$22,000	$ **(5)**
Building and equipment	92,000	**(6)**
Accumulated depreciation	(25,000)	**(7)**
Land	**(1)**	**(8)**
Goodwill	12,000	**(9)**
Total assets	$ (?)	$ (?)
Current liabilities	$ **(2)**	**(10)**
Bonds payable (8%)	**(3)**	**(11)**
Bond premium	(?)	**(12)**
Deferred income taxes	**(4)**	1,700
Common stock	66,000	**(13)**
Paid-in capital	13,000	**(14)**
Preferred stock	16,000	**(15)**
Retained earnings (deficit)	(6,000)	**(16)**
Treasury stock (at cost)	(9,000)	0
Total liabilities and stockholders' equity	$ (?)	$ (?)

Required:

Number your answer sheet from (1) through (16). Place the correct balance for each balance-sheet account or group of accounts next to the corresponding number on your answer sheet. Show supporting computations in good form. (One account balance and the totals are shown as a question mark (?). Calculation of these amounts may be necessary to calculate the numbered balances, but is **not** required to be shown separately in your numbered answers.) **Do not recopy the balance sheets. Calculation of answers need not follow the numerical order of these blanks 1 through 16. Do not restate the January 1 balance sheet for the error.**

Number 5 (Estimated time — 40 to 50 minutes)

You have been engaged by Gary Corporation to calculate its federal taxable income including supporting computations. You have abstracted the following information from Gary's income statement for the year ended December 31, 1974:

Gross margin	$814,700
Interest received on a state bond	6,250
Deductible expenses **except as indicated below**	725,500

You have also gathered the following information from Gary's accounting records and a variety of other sources. None of this additional information was included in the above information abstracted from Gary's income statement.

- The Corporation is beneficiary of life insurance policies on the lives of several of its corporate officers. During 1974, total premiums paid by Gary for these policies were $14,600. During 1974, one of the insured corporate officers died. The corporation received $75,000 as the beneficiary on the policy.
- Mr. Phil, as attorney for Gary, had performed legal services for the Corporation. He was compensated with 100 shares of Gary Corporation common stock, which he accepted in lieu of cash as full payment for the services. On the date he was given this stock, it had a par value of $22 per share and a market value of $55 per share.
- Gary gave $7,350 cash to various charities during 1974.
- Gary owns 40% of the outstanding stock of Glipwood, Inc., a domestic corporation. An analysis of the changes in the investment in Glipwood, Inc., during 1974 follows:

Balance, January 1, 1974	$524,000
Equity in the 1974 net income of Glipwood	120,000
Dividends received during 1974 from Glipwood	(40,000)
Balance, December 31, 1974	$604,000

- Gary paid dividends of $25,000 during 1974.
- At the end of 1974, Gary sold 50 shares of treasury stock for $60 per share. Gary had purchased these shares a year earlier at $52 per share.
- Zeal, Inc., a domestic corporation, sold some investments to Gary, one of Zeal's stockholders, for $4,500. These investments had an adjusted basis to Zeal of $6,000 and a fair market value of $6,350.
- At the beginning of 1972, the Chamber of Commerce of Wolf City gave Gary some equipment as an incentive to open a plant there. This equipment had a fair market value at that time of $50,000. This equipment was sold in July 1974 for $48,000. Depreciation recorded for accounting purposes through the date of sale was as follows:

Year	*Amount*
1972	$ 5,000
1973	5,000
1974	2,500
	$12,500

Total depreciation expense for 1974 including the depreciation on the above equipment was $36,700.

- During 1974 Gary sold a warehouse owned and used by the Corporation. The selling price was $96,000 and its adjusted basis was $128,000. The warehouse had cost $158,000 in 1972 and was depreciated using an accelerated method for tax and accounting purposes. Straight-line depreciation would have been $18,000 during the time the warehouse was owned.
- On January 28, 1974, Gary sold land in Bilk City which it had held as an investment. The selling price was $60,000. This land in Bilk City had been acquired on February 6, 1973, in exchange for another parcel of land in Astor City which also had been held by Gary as an investment. In addition to the land in Bilk City, Gary had also received $5,200 cash on this exchange. The land in Astor City had cost $64,400 in 1970. On February 6, 1973, the land in Bilk City and Astor City had fair market values of $65,000 and $70,200, respectively.

Required:

a. Prepare a schedule computing Gary Corporation's federal taxable income for the year ended December 31, 1974. Any possible alternative treatments should be resolved in a manner that will minimize taxable income. Show supporting computations in good form. Assume that all calculations for prior federal tax returns have been correct, and that all returns have been properly filed.

b. List the items that did **not** affect the determination of taxable income in part **a.** above.

Uniform Certified Public Accountant Examination

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING PRACTICE — PART II

May 8, 1975; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

	Estimated Minutes	
All questions are required:	*Minimum*	*Maximum*
No. 1	40	50
No. 2	50	60
No. 3	30	40
No. 4	40	50
No. 5	60	70
Total	220	270

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, number the pages in sequence for that question with the lead schedule first, followed by supporting computations. For instance, if you use three pages for Question No. 3, you should show Question 3, Page 1 of 3, Page 2 of 3, and Page 3 of 3. The printed answer sheet provided for the objective-type items should be considered to be Page 1.
2. **Enclose all scratch sheets.** Failure to enclose scratch sheets may result in loss of grading points. Scratch sheets need not have page numbers, but you should show the question number and place them immediately following the question to which they relate.
3. Fourteen-column sheets should not be folded until all sheets, both wide and narrow, are placed in the proper sequence and fastened together at the top left corner. All fourteen-column sheets should then be wrapped around the back of the papers.
4. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 40 to 50 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of financial-accounting problems.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to $5,260,000; sales returns and allowances reduced the amounts owed by $160,000. How much were net sales last year for Baker Company?
    a. $4,800,000.
    b. $5,100,000.
    c. $5,200,000.
    d. $5,260,000.

Answer Sheet

97. a. :::::::::: b. ▬▬▬ c. :::::::::: d. ::::::::::

Items to be Answered

1. Williamson Company exchanged 100 shares of treasury stock (its $50 par value common stock) for some land to be used in its business. The treasury stock had cost $60 per share, and on the exchange date, it had a fair market value of $65 per share. Williamson received $1,200 for scrap when an existing building was immediately removed from this land. Based on these facts, at what amount should this land be capitalized?
    a. $3,800.
    b. $4,800.
    c. $5,300.
    d. $6,500.

Items 2 and 3 are based on the following information:

Corporation A purchased the net assets of Corporation B for $80,000. On the date of A's purchase, Corporation B had no long-term investments in marketable securities and $10,000 (book and fair value) of liabilities. The fair values of Corporation B's assets, when acquired, were:

Current assets	$ 40,000
Noncurrent assets	60,000
Total	$100,000

2. How should the $10,000 difference between the fair value of the net assets acquired ($90,000) and the cost ($80,000) be accounted for by Corporation A?
    a. The $10,000 difference should be credited to retained earnings.
    b. The noncurrent assets should be recorded at $50,000.
    c. The current assets should be recorded at $36,000, and the noncurrent assets should be recorded at $54,000.
    d. A deferred credit of $10,000 should be set up and then amortized to income over a period **not** to exceed forty years.

3. Assume that Corporation A paid $110,000 for Corporation B's net assets, and that all other information given above remains the same. What is the minimum annual difference between financial-accounting income and tax income because of this purchase?
    a. Zero.
    b. $500.
    c. $2,000.
    d. **Cannot** be determined from the information given.

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4. Burns Co., an installment seller of furniture, records sales on the accrual basis for financial-reporting purposes but on the installment method for tax purposes. As a result, $50,000 of deferred income taxes have been accrued at December 31, 1974. In accordance with trade practice, installment accounts receivable from customers are shown as current assets, although the average collection period is approximately three years.

    At December 31, 1974, Burns Co. has recorded a $20,000 deferred income tax debit arising from a book accrual of noncurrent deferred compensation expense which is **not** presently tax deductible.

    Also, at December 31, 1974, Burns has accrued $15,000 of deferred income taxes resulting from the use of accelerated depreciation for tax purposes and straight-line depreciation for financial-reporting purposes.

    How should the deferred income taxes be shown on Burns' December 31, 1974, balance sheet?
    a. Current deferred income tax debit of $50,000; noncurrent deferred income tax debit of $20,000; and noncurrent deferred income tax credit of $15,000.
    b. Current deferred income tax credit of $50,000; current deferred income tax debit of $20,000; and noncurrent deferred income tax credit of $15,000.
    c. Noncurrent deferred income tax debit of $20,000; and noncurrent deferred income tax credit of $65,000.
    d. Current deferred income tax credit of $50,000; and noncurrent deferred income tax debit of $5,000.

Items 5 and 6 are based on the following information:

On January 2, 1973, Kirk Manufacturing Company leased some equipment from Quarter Corporation. This lease was noncancelable and was in substance an installment purchase. The initial term of the lease was twelve years with title passing to Kirk at the end of the twelfth year upon payment of $1. Annual rental to be paid by Kirk is $10,000 at the beginning of each year. The first rental payment was made on January 2, 1973, and **no** deposit was required. The equipment has an estimated useful life of twenty years with **no** anticipated salvage value. The prevailing interest rate for Kirk on similar financing arrangements is 8%.

Present Value of An Annuity in Advance of $1 at 8%

11 years	$ 7.710
12 years	8.139
19 years	10.372
20 years	10.604

5. At what amount should Kirk have capitalized this equipment?
   a. $77,100.
   b. $81,390.
   c. $103,720.
   d. $106,040.

6. If the equipment had been capitalized at $90,000 and all other facts remain as originally stated, how much interest expense should Kirk have recorded in 1973?
   a. Zero.
   b. $6,400.
   c. $7,200.
   d. $9,600.

Items 7, 8, and 9 are based on the following information:

Glow Company's December 31 year-end financial statements contained the following errors:

	December 31, 1973	*December 31, 1974*
Ending inventory	$2,000 understated	$1,800 overstated
Depreciation expense	$400 understated	–

An insurance premium of $1,500 was prepaid in 1973 covering the years 1973, 1974, and 1975. The entire amount was charged to expense in 1973. In addition, on December 31, 1974, fully depreciated machinery was sold for $3,200 cash, but the sale was **not** recorded until 1975. There were **no** other errors during 1973 or 1974 and **no** corrections have been made for any of the errors. **Ignore income tax considerations.**

7. What is the total effect of the errors on 1974 net income?
   a. Net income overstated by $600.
   b. Net income overstated by $700.
   c. Net income understated by $900.
   d. Net income overstated by $1,100.

8. What is the total effect of the errors on the amount of Glow's working capital at December 31, 1974?
   a. Working capital overstated by $1,000.
   b. Working capital understated by $1,400.
   c. Working capital understated by $1,500.
   d. Working capital understated by $1,900.

9. What is the total effect of the errors on the balance of Glow's retained earnings at December 31, 1974?
   a. Retained earnings understated by $900.
   b. Retained earnings understated by $1,500.
   c. Retained earnings understated by $1,700.
   d. Retained earnings overstated by $1,900.

10. In 1967, Mr. Heabert purchased land for $7,000. In 1972, he died leaving the land to Sam, his son. The land was appraised at $8,500 at the date of death, and that value was accepted for estate tax purposes. In December 1974 the land was appraised at $9,500. How should the land be recorded on Sam's personal financial statement of assets and liabilities as of December 31, 1974?
    a. Cost of zero and appraised value of $9,500.
    b. Cost of $7,000 and appraised value of $9,500.
    c. Cost of $8,500 and appraised value of $9,500.
    d. Appraised value of $9,500 only.

11. On January 16, 1974, Blue, Inc., granted its employees options to purchase 10,000 shares of its common stock. These options were exercisable beginning immediately and ran for three years from the date of the grant. The options were considered as additional employee compensation. Relevant data follow:

Par value of stock	$6 per share
Market price at January 16, 1974	$9 per share
Option price	$9 per share
Options exercised May 1, 1974	5,000 shares
Market price at May 1, 1974	$12 per share

Blue is a calendar-year company. The remaining options were **not** exercised during 1974. How much should Blue have recorded in 1974 as compensation expense and deferred compensation, respectively?
    a. Zero for both.
    b. $10,000 and $20,000.
    c. $15,000 and $15,000.
    d. $30,000 and zero.

Items 12, 13, and 14 are based on the following information:

The following data have been abstracted from the financial statements of Prentiss, Inc., a calendar-year merchandising corporation:

- Balance sheet data:

	December 31, 1973	*December 31, 1974*
Trade accounts receivable – net	$ 84,000	$ 78,000
Inventory	150,000	140,000
Accounts payable – merchandise (credit)	(95,000)	(98,000)

- Total sales for 1974 were $1,200,000 and for 1973 were $1,100,000. Cash sales were 20% of total sales each year.
- Cost of goods sold was $840,000 for 1974.
- Variable general and administrative (G&A) expenses for 1974 were $120,000. They have varied in proportion to sales and have been paid 50% in the year incurred and 50% the following year. Unpaid G&A expenses are **not** included in accounts payable above.
- Fixed general and administrative expenses including $35,000 depreciation and $5,000 bad debt expense totaled $100,000 each year. The amount of such expenses involving cash payments was paid 80% in the year incurred and 20% the following year. Each year there were a $5,000 bad debt estimate and a $5,000 write-off. Unpaid G&A expenses are **not** included in accounts payable above.

12. How much cash was collected during 1974 resulting from total sales in 1973 and 1974?
  a. $961,000.
  b. $966,000.
  c. $1,201,000.
  d. $1,206,000.

13. How much cash was disbursed during 1974 for purchases of merchandise?
  a. $818,700.
  b. $827,000.
  c. $838,500.
  d. $847,000.

14. How much cash was disbursed during 1974 for variable and fixed general and administrative expenses?
  a. $175,000.
  b. $180,000.
  c. $215,000.
  d. $220,000.

15. Smith Company has 1,000,000 shares of common stock authorized with a par value of $3 per share of which 300,000 shares are outstanding. Smith authorized a stock dividend when the market value was $8 per share, entitling its stockholders to one additional share for each share held. The par value of the stock was **not** changed. What entry, if any, should Smith make to record this transaction?

a.	No entry.		
b.	Retained earnings	$900,000	
	Common stock		$900,000
c.	Retained earnings	2,400,000	
	Common stock		900,000
	Capital in excess of par		1,500,000
d.	Stock dividend payable	900,000	
	Retained earnings	900,000	
	Common stock		1,800,000

Number 2 (Estimated time — 50 to 60 minutes)

Instructions

Select the **best** answer for each of the following items relating to the **federal income taxation of individuals and partnerships**. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. The answers should be selected in accordance with the **current Internal Revenue Code and Tax Regulations. Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

16. Cal, Dave, and Ed are partners sharing profits and losses 40:20:40, respectively. The partnership received dividends in 1974 of $800 from domestic corporations. By how much will the partnership's ordinary income be increased because of these dividends?
  a. $0.
  b. $120.
  c. $500.
  d. $800.
  e. None of the above.

17. The Bid Partnership had a 1974 ordinary operating loss of $42,000. Its two partners share profits and losses equally. Partner Alton had an adjusted partnership interest and tax basis of $12,000 at the end of 1974. Total partners' capital and tax basis on that date were $36,000. How much can Alton deduct on his 1974 income tax return as his share of the loss?
  a. $0.
  b. $12,000.
  c. $18,000.
  d. $21,000.
  e. None of the above.

18. Sam owns 55% interest in the capital and profits of the Gemini partnership. This year he transferred property to the partnership. On the date of transfer, the property had an adjusted tax basis to Sam of $26,300 and a fair market value of $25,000. What amount and type of loss, if any, can Sam recognize in his income tax return for the year in which the property was transferred to the partnership?

a. No gain or loss.
b. $650 capital loss.
c. $1,300 ordinary loss.
d. $1,300 capital loss.
e. None of the above.

19. Crater Partnership had 1974 net ordinary income of $45,000 and a net long-term capital gain of $5,000. Mr. Abbott, who has a 20% interest in the profits and losses of the partnership, had 1974 drawings of $12,500 from the partnership. The other partners withdrew $27,500 during 1974. The partnership agreement does **not** provide for partner salaries or bonuses. Mr. Abbott had **no** other capital gains or losses during 1974. By how much will Mr. Abbott's 1974 adjusted gross income increase because of his interest in Crater Partnership?

a. $2,000.
b. $8,000.
c. $9,000.
d. $10,000.
e. None of the above.

20. Mrs. Blackton maintains her home in which she and her daughter reside. Her daughter does **not** qualify as her dependent. Mrs. Blackton's husband died in 1973. What is Mrs. Blackton's filing status for 1974?

a. Single.
b. Surviving spouse.
c. Married filing jointly.
d. Head of household.
e. None of the above.

21. Mr. Generous made the following contributions during 1974:

Recipient	*Amount*
Church	$500 pledge of which $350 was paid in cash during 1974
Various individuals	$20 cash
Red Cross	Stock held two months: cost, $140; fair market value at time of donation, $150

Ignoring the standard deduction and assuming his adjusted gross income is $12,000, how much can he deduct in 1974 for charitable contributions?

a. $490.
b. $500.
c. $510.
d. $660.
e. None of the above.

Items 22 and 23 are based on the following information:

Two transactions for a sole proprietorship during 1974 are summarized below.

- Sold a machine used in the business for $40,000. It cost $33,000 when purchased in 1968, and its adjusted tax basis when sold was $21,000. Depreciation had been recorded on an accelerated basis; straight-line depreciation would have been $9,900.
- Received a $50,000 insurance recovery on a small warehouse destroyed by fire and previously used in the business. Its adjusted tax basis at the date of the fire was $52,400. A new warehouse was rebuilt at a cost of $60,000.

22. What is the combined tax effect before the capital-gain deduction of these two transactions?

a. $300 long-term capital loss and $16,900 ordinary income.
b. $4,600 long-term capital gain and $12,000 ordinary income.
c. $19,000 long-term capital gain and $2,400 ordinary loss.
d. $7,000 long-term capital gain; $12,000 ordinary income; and $2,400 adjustment to the tax basis of the new warehouse.
e. None of the above.

23. What is the basis of the new warehouse?

a. $52,400.
b. $57,600.
c. $60,000.
d. $62,400.
e. None of the above.

---

24. Rhona, single, had 1974 adjusted gross income of $18,000 which was computed correctly. She incurred the following expenses in 1974:

Unreimbursed business travel	$ 900
Charity (Red Cross)	450
Doctors and hospital	400
Property taxes and interest (nonbusiness)	700
State income taxes	500
Other deductible taxes	150
	$3,100

Ignoring personal exemptions, what is Rhona's maximum 1974 deduction from adjusted gross income?

a. $1,800.
b. $2,000.
c. $2,200.
d. $3,100.
e. None of the above.

25. Mr. Beth, a sole proprietor on the accrual basis, prepared the following balance sheet for his business on December 15, 1974:

Assets

Accounts receivable		$ 8,000
Inventory		14,000
Equipment (purchased in 1964)	$40,000	
Accumulated depreciation	30,000	10,000
Goodwill (tax basis)		15,000
		$47,000

Capital

Beth, Capital	$47,000

On December 15, 1974, Mr. Beth sold this business. The allocation of the selling price of $63,000 was stipulated in the sales agreement as follows:

Accounts receivable	$ 8,000
Inventory	17,000
Equipment	16,000
Goodwill	22,000
Total selling price	$63,000

How should this sale be reported in Mr. Beth's 1974 individual tax return? **The long-term capital gain deduction, if any, should be ignored.**

a. Zero long-term capital gain and $16,000 ordinary income.
b. Zero ordinary income and $16,000 long-term capital gain.
c. $3,000 ordinary income and $13,000 long-term capital gain.
d. $9,000 ordinary income and $7,000 long-term capital gain.
e. None of the above.

26. James purchased an automobile on January 2, 1971, for $4,000. The automobile had an estimated life of four years and an estimated salvage value of $800. The automobile was used 75% for business and 25% for personal use throughout the time that James owned it. James used straight-line depreciation. He sold the automobile for $1,000 cash on December 31, 1974. What is the effect of this sale on James' 1974 individual income tax return?

a. $450 ordinary loss and $150 loss **not** deductible.
b. $150 ordinary income and $750 loss **not** deductible.
c. $600 ordinary loss.
d. $600 loss **not** deductible.
e. None of the above.

27. Mr. Norton, a calendar-year taxpayer, purchased an annuity contract which pays him $54 per month beginning June 1, 1974. This annuity cost him $2,400, and it has an expected return of $7,200. How much of this annuity is **includable** in gross income for the 1974 calendar year?

a. Zero.
b. $126.
c. $252.
d. $378.
e. None of the above.

28. Mr. and Mrs. Kahn, both 52, filed a joint return for 1974. They fully supported their son who is 16 and legally blind and who had **no** income. Their daughter, a full-time student at a university, had $5,000 of income and supported herself to the extent of 60% during 1974. How many exemptions should Mr. and Mrs. Kahn have claimed on their 1974 joint tax return?

a. 2.
b. 3.
c. 4.
d. 5.
e. None of the above.

29. In 1974, Mr. Trader had a net long-term capital loss of $13,000 and a net short-term capital gain of $8,000. What are his 1974 capital loss deduction and carryover to 1975, respectively?

a. $1,000 and $3,000.
b. $1,000 and $4,000.
c. $2,500 and zero.
d. $2,500 and $2,500.
e. None of the above.

30. Which of the following is deductible to arrive at adjusted gross income?

a. Unreimbursed dues to AICPA by an employee of an accounting firm.
b. Unreimbursed union dues by an employee of a company.
c. Medical expenses of a self-employed individual.
d. One-half of a net short-term capital gain in excess of a net long-term capital loss.
e. None of the above.

31. In 1972, Martha received as a gift several shares of Good Corporation stock. The donor's basis of this stock was $2,800, and he paid gift tax of $50. On the date of the gift, the fair market value of the stock was $2,600. If Martha sells this stock in 1974 for $2,700, what amount and type of gain or loss should Martha report in her 1974 income tax return?

a. $50 long-term capital gain.
b. $100 long-term capital gain.
c. $100 long-term capital loss.
d. $150 long-term capital loss.
e. None of the above.

Number 3 (Estimated time -- 30 to 40 minutes)

Your client, Ocean Company, manufactures and sells three different products – Ex, Why, and Zee. Projected income statements by product line for the year ended December 31, 1976, are presented below:

	Ex	*Why*	*Zee*	*Total*
Unit Sales	10,000	500,000	125,000	635,000
Revenues	$ 925,000	$1,000,000	$575,000	$2,500,000
Variable cost of units sold	285,000	350,000	150,000	785,000
Fixed cost of units sold	304,200	289,000	166,800	760,000
Gross margin	335,800	361,000	258,200	955,000
Variable general and administrative (G&A) expenses	270,000	200,000	80,000	550,000
Fixed G&A expenses	125,800	136,000	78,200	340,000
Income (loss) before tax	$ (60,000)	$ 25,000	$100,000	$ 65,000

Production costs are similar for all three products. The fixed G&A expenses are allocated to products in proportion to revenues. The fixed cost of units sold is allocated to products by various allocation bases, such as square feet for factory rent and machine hours for repairs, etc.

Ocean management is concerned about the loss for product Ex and is considering two alternative courses of corrective action.

Alternative A – Ocean would purchase some new machinery for the production of product Ex. This new machinery would involve an immediate cash outlay of $650,000. Management expects that the new machinery would reduce variable production costs so that total variable costs (cost of units sold and G&A expenses) for product Ex would be 52% of product Ex revenues. The new machinery would increase total fixed costs allocated to product Ex to $480,000 per year. No additional fixed costs would be allocated to products Why or Zee.

Alternative B – Ocean would discontinue the manufacture of product Ex. Selling prices of products Why and Zee would remain constant. Management expects that product Zee production and revenues would increase by 50%. Some of the present machinery devoted to product Ex could be sold at scrap value which equals its removal costs. The removal of this machinery would reduce fixed costs allocated to product Ex by $30,000 per year. The remaining fixed costs allocated to product Ex include $155,000 of rent expense per year. The space previously used for product Ex can be rented to an outside organization for $157,500 per year.

Required:

Prepare a schedule analyzing the effect of Alternative A and Alternative B on projected total company income before tax.

Number 4 (Estimated time — 40 to 50 minutes)

The following schedule sets forth the short-term debt, long-term debt, and stockholders' equity of Darren Company as of December 31, 1974. The president of Darren has requested that you assist the controller in preparing figures for earnings per share computations.

Short-term debt:	
Notes payable - banks	$ 4,000,000
Current portion of long-term debt	10,000,000
Total short-term debt	$ 14,000,000
Long-term debt:	
4% convertible debentures due April 15, 1986	$ 30,000,000
Other long-term debt less current portions	20,000,000
Total long-term debt	50,000,000
Stockholders' equity:	
$4.00 cumulative, convertible preferred stock; par value $20 per share; authorized 2,000,000 shares; issued and outstanding 1,200,000 shares; liquidation preference $30 per share aggregating $36,000,000	24,000,000
Common stock; par value $1 per share; authorized 20,000,000 shares; issued 7,500,000 shares including 600,000 shares held in treasury	7,500,000
Additional paid-in capital	4,200,000
Retained earnings	76,500,000
Total	112,200,000
Less cost of 600,000 shares of common stock held in treasury (acquired prior to 1974)	900,000
Total stockholders' equity	111,300,000
Total long-term debt and stockholders' equity	$161,300,000

Explanation of Short-Term Debt, Long-Term Debt, and Stockholders' Equity Including Transactions During the Year Ended December 31, 1974

- The "Other long-term debt" and the related amounts due within one year are amounts due on unsecured promissory notes which require payments each year to maturity. The interest rates on these borrowings range from 6% to 7%. At the time that these monies were borrowed, the bank prime interest rate was 7%.
- The 4% convertible debentures were issued at their face value of $30,000,000 in 1956 when the bank prime interest rate was 5%. The debentures are due in 1986 and until then are convertible into the common stock of Darren at the rate of 25 shares for each $1,000 debenture.
- The $4.00 cumulative, convertible preferred stock was issued in 1973. The stock had a market value of $75 at the time of issuance when the bank prime interest rate was 9%. On July 1, 1974, and on October 1, 1974, holders of the preferred stock converted 80,000 and 20,000 preferred shares, respectively, into common stock. Each share of preferred stock is convertible into 1.2 shares of common stock.
- On April 1, 1974, Darren acquired the assets and business of Brett Industries by the issuance of 800,000 shares of Darren common stock in a transaction appropriately accounted for as a purchase.
- On October 1, 1973, the company granted options to its officers and selected employees to purchase 100,000 shares of Darren's common stock at a price of $33 per share. The options are **not** exercisable until 1976.

Additional information:

- The average and ending market prices during 1974 of Darren common stock were as follows:

	Average Market Price	*Ending Market Price*
First Quarter	$31	$29
Second Quarter	33	32
Third Quarter	35	33
Fourth Quarter	37	34
Average for the year	34	—
December 31, 1974	—	34

- Dividends on the preferred stock have been paid through December 31, 1974. Dividends paid on the common stock were $0.50 per share for each quarter.
- The net income of Darren Company for the year ended December 31, 1974, was $8,600,000. There were **no** extraordinary items. The provision for income taxes was computed at a rate of 48%.

Required:

a. Prepare a schedule which shows the adjusted number of shares for 1974 to compute:

1. Primary earnings per share.
2. Fully diluted earnings per share.

b. Prepare a schedule which shows the adjusted net income for 1974 to compute:

1. Primary earnings per share.
2. Fully diluted earnings per share.

Do not compute earnings per share.

Number 5 (Estimated time -- 60 to 70 minutes)

On April 1, 1974, Jared, Inc., purchased 100% of the common stock of Munson Manufacturing Company for \$5,850,000 and 20% of its preferred stock for \$150,000. At the date of purchase the book and fair values of Munson's assets and liabilities were as follows:

	Book Value	*Fair Value*
Cash	\$ 200,000	\$ 200,000
Notes receivable	85,000	85,000
Accounts receivable, net	980,000	980,000
Inventories	828,000	700,000
Land	1,560,000	2,100,000
Machinery and equipment	7,850,000	10,600,000
Accumulated depreciation	(3,250,000)	(4,000,000)
Other assets	140,000	50,000
	\$8,393,000	\$10,715,000
Notes payable	\$ 115,000	\$ 115,000
Accounts payable	400,000	400,000
Subordinated debentures – 7%	5,000,000	5,000,000
Preferred stock; noncumulative, nonparticipating, par value \$5 per share; authorized, issued and outstanding 150,000 shares	750,000	–
Common stock; par value \$10 per share; authorized, issued, and outstanding 100,000 shares	1,000,000	–
Additional paid-in capital (common stock)	122,000	–
Retained earnings	1,006,000	–
	\$8,393,000	

Additional information:

By the year end, December 31, 1974, the following transactions had occurred:

- The balance of Munson's net accounts receivable at April 1, 1974, had been collected.
- The inventory on hand at April 1, 1974, had been charged to cost of sales. Munson used a perpetual inventory system in accounting for inventories.
- Prior to 1974, Jared had purchased at face value \$1,500,000 of Munson's 7% subordinated debentures. These debentures mature on October 31, 1980, with interest payable annually on October 31.
- As of April 1, 1974, the machinery and equipment had an estimated remaining life of six years. Munson uses the straight-line method of depreciation. Munson's depreciation expense calculation for the *nine months ended* December 31, 1974, was based upon the old depreciation rates.
- The other assets consist entirely of long-term investments made by Munson and do **not** include any investment in Jared.
- During the last nine months of 1974, the following intercompany transactions occurred between Jared and Munson.

Intercompany sales:

	Jared to Munson	*Munson to Jared*
Net sales	\$158,000	\$230,000
Included in purchaser's inventory at December 31, 1974	36,000	12,000
Balance unpaid at December 31, 1974	16,800	22,000

Jared sells merchandise to Munson at cost. Munson sells merchandise to Jared at regular selling price including a normal gross profit margin of 35 percent. There were **no** intercompany sales between the two companies prior to April 1, 1974.

Accrued interest on intercompany debt is recorded by both companies in their respective accounts receivable and accounts payable accounts.

- The account, "Investment in Munson Manufacturing Company," includes Jared's investment in Munson's debentures and its investment in the common and preferred stock of Munson.
- Jared's policy is to amortize intangible assets over a twenty-year period.

Required:

Complete the worksheet on page 128 to prepare the consolidated trial balance for Jared, Inc., and its subsidiary, Munson Manufacturing Company, at December 31, 1974. Show computations in good form where appropriate to support worksheet entries.

Jared's revenue and expense figures are for the twelve-month period while Munson's are for the last nine months of 1974. You may assume that both companies made all the adjusting entries required for separate financial statements unless stated to the contrary. Round all computations to the nearest dollar. **Ignore income taxes.**

Jared, Inc., and Subsidiary

WORKSHEET TO PREPARE CONSOLIDATED TRIAL BALANCE

December 31, 1974

(Required for Number 5)

	Jared, Inc. Dr. (Cr.)	Munson Mfg. Co. Dr. (Cr.)	Adjustments and Eliminations Debit	Adjustments and Eliminations Credit	Consolidated Balances Debit	Consolidated Balances Credit
Cash	$ 822,000	$ 530,000				
Notes receivable	–	85,000				
Accounts receivable, net	2,758,000	1,368,400				
Inventories	3,204,000	1,182,000				
Land	4,000,000	1,560,000				
Machinery and equipment	15,875,000	7,850,000				
Accumulated depreciation —machinery and equipment	(6,301,000)	(3,838,750)				
Buildings	1,286,000	–				
Accumulated depreciation – buildings	(372,000)	–				
Investment in Munson Manufacturing Company	7,500,000	–				
Other assets	263,000	140,000				
Notes payable	–	(115,000)				
Accounts payable	(1,364,000)	(204,000)				
Long-term debt	(10,000,000)	–				
Subordinated debentures – 7%	–	(5,000,000)				
Preferred stock	–	(750,000)				
Common stock	(2,400,000)	(1,000,000)				
Additional paid-in capital	(240,000)	(122,000)				
Retained earnings	(12,683,500)	–				
Retained earnings	–	(1,006,000)				
Sales	(18,200,000)	(5,760,000)				
Cost of sales	10,600,000	3,160,000				
Selling, general, and administrative expenses	3,448,500	1,063,900				
Depreciation expense – machinery and equipment	976,000	588,750				
Depreciation expense – buildings	127,000	–				
Interest revenue	(105,000)	(1,700)				
Interest expense	806,000	269,400				
	$ -0-	$ -0-				

Uniform Certified Public Accountant Examination

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN AUDITING

May 8, 1975; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	35	40
No. 2	35	40
No. 3	20	25
No. 4	20	25
No. 5	20	30
No. 6	20	25
No. 7	20	25
Total for examination	170	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 35 to 40 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

96. One of the generally accepted auditing standards specifies that the auditor
    a. Inspect all the fixed assets acquired during the year.
    b. Charge fair fees based on cost.
    c. Make a proper study and evaluation of the existing internal control.
    d. May not solicit clients.

Answer Sheet

96. a. :::::::::: b. :::::::::: c. ▬▬ d. ::::::::::

Items to be Answered

1. Which of the following material events occurring subsequent to the balance sheet date would require an adjustment to the financial statements before they could be issued?
    a. Sale of long-term debt or capital stock.
    b. Loss of a plant as a result of a flood.
    c. Major purchase of a business which is expected to double the sales volume.
    d. Settlement of litigation, in excess of the recorded liability.

2. What is the meaning of the generally accepted auditing standard which requires that the auditor be independent?
    a. The auditor must be without bias with respect to the client under audit.
    b. The auditor must adopt a critical attitude during the audit.
    c. The auditor's sole obligation is to third parties.
    d. The auditor may have a direct ownership interest in his client's business if it is not material.

3. Because of the technical nature and complexity of internal accounting control and the consequent problem of understanding reports thereon, questions have been raised as to the benefits of such reports prepared by independent auditors. Which of the following groups probably would find a report on internal control **least** useful?
    a. Regulatory agencies.
    b. General creditors.
    c. Management.
    d. Internal auditors.

4. When are an auditor's reporting responsibilities **not** met by attaching an explanation of the circumstances and a disclaimer of opinion to the client's financial statements?
    a. When he believes the financial statements are misleading.
    b. When he was unable to observe the taking of the physical inventory.
    c. When he is uncertain about the outcome of a material contingency.
    d. When he has performed insufficient auditing procedures to express an opinion.

5. Which of the following is prohibited by the AICPA Code of Professional Ethics?
    a. Use of a firm name which indicates specialization.
    b. Practice of public accounting in the form of a professional corporation.
    c. Use of the partnership name for a limited period by one of the partners in a public accounting firm after the death or withdrawal of all other partners.
    d. Holding as an investment ten of 1,000 outstanding shares in a commercial corporation which performs bookkeeping services.

6. Which of the following situations would require adjustment to or disclosure in the financial statements?
    a. A merger discussion.
    b. The application for a patent on a new production process.
    c. Discussions with a customer that could lead to a forty percent increase in the client's sales.
    d. The bankruptcy of a customer who regularly purchased thirty percent of the company's output.

7. Which of the following types of documentary evidence should the auditor consider to be the most reliable?
    a. A sales invoice issued by the client and supported by a delivery receipt from an outside trucker.
    b. Confirmation of an account-payable balance mailed by and returned directly to the auditor.
    c. A check issued by the company and bearing the payee's indorsement which is included with the bank statement mailed directly to the auditor.
    d. A working paper prepared by the client's controller and reviewed by the client's treasurer.

8. When is the auditor responsible for detecting fraud?
    a. When the fraud did not result from collusion.
    b. When third parties are likely to rely on the client's financial statements.
    c. When the client's system of internal control is judged by the auditor to be inadequate.
    d. When the application of generally accepted auditing standards would have uncovered the fraud.

9. What is the general character of the three generally accepted auditing standards classified as standards of field work?
   a. The competence, independence, and professional care of persons performing the audit.
   b. Criteria for the content of the auditor's report on financial statements and related footnote disclosures.
   c. The criteria of audit planning and evidence-gathering.
   d. The need to maintain an independence in mental attitude in all matters relating to the audit.

10. Which of the following best describes the responsibility of the CPA when he prepares unaudited financial statements for his client?
   a. He should make a proper study and evaluation of the existing internal control as a basis for reliance thereon.
   b. He is relieved of any responsibility to third parties.
   c. He does not have responsibility to apply auditing procedures to the financial statements.
   d. He has only to satisfy himself that the financial statements were prepared in conformity with generally accepted accounting principles.

11. A CPA's report accompanying a cash forecast or other type of projection should
   a. Not be issued in any form because it would be in violation of the AICPA Code of Professional Ethics.
   b. Disclaim any opinion as to the forecast's achievability.
   c. Be prepared only if the client is a not-for-profit organization.
   d. Be a qualified short-form audit report if the business concern is operated for a profit.

12. In which one of the following situations must the CPA issue a disclaimer of opinion?
   a. He owns stock in the company.
   b. Some portion of the client's financial statements does not conform to generally accepted accounting principles.
   c. He has omitted a normally required auditing procedure.
   d. Generally accepted accounting principles have not been applied on a basis consistent with that of the preceding year.

13. What is the computer process called when data processing is performed concurrently with a particular activity and the results are available soon enough to influence the particular course of action being taken or the decision being made?
   a. Realtime processing.
   b. Batch processing.
   c. Random access processing.
   d. Integrated data processing.

14. Keller, CPA, was about to issue an unqualified opinion on the audit of Lupton Television Broadcasting Company when he received a letter from Lupton's independent counsel. The letter stated that the Federal Communications Commission has notified Lupton that its broadcasting license will **not** be renewed because of some alleged irregularities in its broadcasting practices. Lupton **cannot** continue to operate without this license. Keller has also learned that Lupton and its independent counsel plan to take all necessary legal action to retain the license. The letter from independent counsel, however, states that a favorable outcome of any legal action is highly uncertain. Based on this information what action should Keller take?
   a. Issue a qualified opinion, subject to the outcome of the license dispute, with disclosure of the substantive reasons for the qualification in a separate explanatory paragraph of his report.
   b. Issue an unqualified opinion if full disclosure is made of the license dispute in a footnote to the financial statements.
   c. Issue an adverse opinion on the financial statements and disclose all reasons therefore.
   d. Issue a piecemeal opinion with full disclosure made of the license dispute in a footnote to the financial statements.

15. When the auditor's regular examination leading to an opinion on financial statements discloses specific circumstances that make him suspect that fraud may exist and he concludes that the results of such fraud, if any, could **not** be so material as to affect his opinion, he should
   a. Make a note in his working papers of the possibility of a fraud of immaterial amount so as to pursue the matter next year.
   b. Reach an understanding with the client as to whether the auditor or the client, subject to the auditor's review, is to make the investigation necessary to determine whether fraud has occurred and, if so, the amount thereof.
   c. Refer the matter to the appropriate representatives of the client with the recommendation that it be pursued to a conclusion.
   d. Immediately extend his audit procedures to determine if fraud has occurred and, if so, the amount thereof.

16. The standard short-form auditor's report is generally considered to have a scope paragraph and an opinion paragraph. In the report the auditor refers to both generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS). In which of the paragraphs are these terms used?
   a. GAAP in the scope paragraph and GAAS in the opinion paragraph.
   b. GAAS in the scope paragraph and GAAP in the opinion paragraph.
   c. GAAS in both paragraphs and GAAP in the scope paragraph.
   d. GAAP in both paragraphs and GAAS in the opinion paragraph.

17. A CPA is engaged in the annual audit of a client for the year ended December 31, 1974. The client took a complete physical inventory under the CPA's observation on December 15 and adjusted its inventory control account and detailed perpetual inventory records to agree with the physical inventory. The client considers a sale to be made in the period that goods are shipped. Listed below are four items taken from the CPA's sales-cutoff-test worksheet. Which item does **not** require an adjusting entry on the client's books?

	Date (Month/Day)		
	Shipped	*Recorded as Sale*	*Credited to Inventory Control*
a.	12/10	12/19	12/12
b.	12/14	12/16	12/16
c.	12/31	1/2	12/31
d.	1/2	12/31	12/31

18. What is the primary objective of using stratification as a sampling method in auditing?
   a. To increase the confidence level at which a decision will be reached from the results of the sample selected.
   b. To determine the occurrence rate for a given characteristic in the population being studied.
   c. To decrease the effect of variance in the total population.
   d. To determine the precision range of the sample selected.

19. An auditor is reporting on cash-basis financial statements. These statements are best referred to in his opinion by which one of the following descriptions?
   a. Cash receipts and disbursements and the assets and liabilities arising from cash transactions.
   b. Financial position and results of operations arising from cash transactions.
   c. Balance sheet and income statement resulting from cash transactions.
   d. Cash balance sheet and the source and application of funds.

20. In which one of the following situations would a CPA be in violation of the AICPA Code of Professional Ethics in determining his fee?
   a. A fee based on whether the CPA's report on the client's financial statements results in the approval of a bank loan.
   b. A fee based on the outcome of a bankruptcy proceeding.
   c. A fee based on the nature of the service rendered and the CPA's particular expertise instead of the actual time spent on the engagement.
   d. A fee based on the fee charged by the prior auditor.

21. Which one of the following procedures would **not** be appropriate for an auditor in discharging his responsibilities concerning the client's physical inventories?
   a. Confirmation of goods in the hands of public warehouses.
   b. Supervising the taking of the annual physical inventory.
   c. Carrying out physical inventory procedures at an interim date.
   d. Obtaining written representation from the client as to the existence, quality, and dollar amount of the inventory.

22. The AICPA Code of Professional Ethics states that a CPA shall **not** disclose any confidential information obtained in the course of a professional engagement except with the consent of his client. In which one of the situations given below would disclosure by a CPA be in violation of the Code?
   a. Disclosing confidential information in order to properly discharge the CPA's responsibilities in accordance with his profession's standards.
   b. Disclosing confidential information in compliance with a subpoena issued by a court.
   c. Disclosing confidential information to another accountant interested in purchasing the CPA's practice.
   d. Disclosing confidential information in a review of the CPA's professional practice by the AICPA Quality Review Committee.

23. Which one of the following statements is correct concerning the concept of materiality?
   a. Materiality is determined by reference to guidelines established by the AICPA.
   b. Materiality depends only on the dollar amount of an item relative to other items in the financial statements.
   c. Materiality depends on the nature of an item rather than the dollar amount.
   d. Materiality is a matter of professional judgment.

24. The auditor recognizes that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments. Which one of the following would the auditor generally consider **least** a part of a manufacturing company's "system" of internal control?
   a. Time and motion studies which are of an engineering nature.
   b. Quarterly audits by an insurance company to determine the premium for workmen's compensation insurance.
   c. A budgetary system installed by a consulting firm other than a CPA firm.
   d. A training program designed to aid personnel in meeting their job responsibilities.

25. As an in-charge auditor you are reviewing a write-up of internal-control weaknesses in cash receipt and disbursement procedures. Which one of the following weaknesses, standing alone, should cause you the **least** concern?
   a. Checks are signed by only one person.
   b. Signed checks are distributed by the controller to approved payees.
   c. Treasurer fails to establish *bona fides* of names and addresses of check payees.
   d. Cash disbursements are made directly out of cash receipts.

Number 2 (Estimated time –– 35 to 40 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

26. King Corp. has received a government grant and asked you, as a CPA, to prepare a report on internal control which is required by the terms of the grant. The governmental agency responsible for the grant has prepared written criteria, including a questionnaire, for such a report. During your study to prepare the report you find what you consider a material internal-control weakness in accounting for the grant. This weakness was not covered by the criteria established by the governmental agency. What action should you take in your report to the governmental agency?
   a. Include the weakness in the report even though not covered by the agency's criteria.
   b. Do not include the weakness in the report because it is outside the criteria established by the agency.
   c. Advise King Corp.'s management but do not include the weakness in the report.
   d. Include a comment in the report that you do not believe the criteria established by the agency are comprehensive but do not include the weakness in the report.

27. In connection with a law suit, a third party attempts to gain access to the auditor's working papers. The client's defense of privileged communication will be successful only to the extent it is protected by the
   a. Auditor's acquiescence in use of this defense.
   b. Common law.
   c. AICPA Code of Professional Ethics.
   d. State law.

28. Internal control can generally be subdivided into administrative controls and accounting controls. The scope of study and evaluation of internal control contemplated by generally accepted auditing standards requires the consideration of
   a. Both administrative controls and accounting controls.
   b. Administrative controls.
   c. Accounting controls.
   d. Accounting controls in an audit engagement and administrative controls in a management advisory service engagement.

29. Harvey, CPA, is preparing an audit program for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements in conformity with generally accepted accounting principles. Which one of the following procedures would be **least** appropriate for this purpose?
   a. Confirm as of the completion of field work accounts receivable which have increased significantly from the year-end date.
   b. Read the minutes of the board of directors.
   c. Inquire of management concerning events which may have occurred.
   d. Obtain a lawyer's letter as of the completion of field work.

30. As part of an audit, a CPA often requests a representation letter from his client. Which one of the following is **not** a valid purpose of such a letter?
   a. To provide audit evidence.
   b. To emphasize to the client his responsibility for the correctness of the financial statements.
   c. To satisfy himself by means of other auditing procedures when certain customary auditing procedures are not performed.
   d. To provide possible protection to the CPA against a charge of knowledge in cases where fraud is subsequently discovered to have existed in the accounts.

31. For a large population of cash disbursement transactions, Smith, CPA, is testing compliance with internal control by using attribute sampling techniques. Anticipating an occurrence rate of 3 percent Smith found from a table that the required sample size is 400 with a desired upper precision limit of 5 percent and reliability of 95 percent. If Smith anticipated an occurrence rate of only 2 percent but wanted to maintain the same desired upper precision limit and reliability the sample size would be closest to
   a. 200.
   b. 400.
   c. 533.
   d. 800.

32. A CPA has completed the initial audit of a new client which has **not** previously been audited. The client has prepared an annual report with comparative financial statements of the prior year which have been marked "unaudited." What comment should the CPA make to his client or in his report relative to the prior year's financial statements?
   a. The CPA should tell his client that if the client wants to include the CPA's report on this year's financial statements in the annual report the client can not include the comparative statements because the CPA has not audited them.
   b. The CPA must add a disclaimer of opinion on the prior year's financial statements to his report.
   c. The CPA must qualify his report to the effect that comparison with the prior year figures may not be valid because they are unaudited.
   d. The CPA need do nothing.

33. George Green, CPA, is preparing a report on internal control. He has already discussed the internal-control weaknesses with the appropriate client officials. During these discussions the client stated that, given its circumstances, there was no practicable corrective action which could be taken for one of the major weaknesses and therefore asked that it not be included in Green's report. In the final analysis, Green concurred that **no** corrective action by management is practicable. Which of the following is the most appropriate course of action for Green to take?
   a. He must include this weakness in his report; otherwise, he will be in violation of generally accepted auditing standards.
   b. He may omit this weakness from his report without any further mention..
   c. He may omit this weakness from his report but should send a confidential memo to the Board of Directors pointing out the nature of the weakness and why it was omitted from his report.
   d. He may omit this weakness from his report but should clearly state that the report is restricted to material weaknesses for which corrective action by management may be practicable in the circumstances.

34. A customer inadvertently ordered part number 12368 rather than part number 12638. In processing this order, the error would be detected by the vendor with which of the following controls?
   a. Batch total.
   b. Key verifying.
   c. Self-checking digit.
   d. An internal consistency check.

Items 35, 36, and 37 are based on the following information:

Listed below are four interbank cash transfers, indicated by the letters a, b, c, and d, of a client for late December 1974 and early January 1975. **Your answer choice for each item 35, 36, and 37, should be selected from this list.**

	Bank Account One Disbursing Date (Month/Day)		*Bank Account Two Receiving Date (Month/Day)*	
	Per Bank	*Per Books*	*Per Bank*	*Per Books*
a.	12/31	12/30	12/31	12/30
b.	1/2	12/30	12/31	12/31
c.	1/3	12/31	1/2	1/2
d.	1/3	12/31	1/2	12/31

35. Which of the cash transfers indicates an error in cash cutoff at December 31, 1974?

36. Which of the cash transfers would appear as a deposit in transit on the December 31, 1974, bank reconciliation?

37. Which of the cash transfers would **not** appear as an outstanding check on the December 31, 1974, bank reconciliation?

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38. To satisfy the auditing standard to make a proper study and evaluation of internal control, Harvey Jones, CPA, uses statistical sampling to test compliance with internal control procedures. Why does Jones use this statistical-sampling technique?
   a. It provides a means of measuring mathematically the degree of reliability that results from examining only a part of the data.
   b. It reduces the use of judgment required of Jones because the AICPA has established numerical criteria for this type of testing.
   c. It increases Jones' knowledge of the client's prescribed procedures and their limitations.
   d. It is specified by generally accepted auditing standards.

39. There are many kinds of statistical estimates that an auditor may find useful, but basically every accounting estimate is either of a quantity or of an error rate. The statistical terms that roughly correspond to "quantities" and "error rate," respectively, are
   a. Attributes and variables.
   b. Variables and attributes.
   c. Constants and attributes.
   d. Constants and variables.

40. Data Corporation has just completely computerized its billing and accounts receivable recordkeeping. You want to make maximum use of the new computer in your audit of Data Corporation. Which of the following audit techniques could **not** be performed through a computer program?

a. Tracing audited cash receipts to accounts receivable credits.
b. Selecting on a random number basis accounts to be confirmed.
c. Examining sales invoices for completeness, consistency between different items, valid conditions and reasonable amounts.
d. Resolving differences reported by customers on confirmation requests.

41. During the course of an audit, the client's controller asks your advice on how to revise the purchase journal so as to reduce the amount of time his staff takes in posting. How should you respond?

a. Explain that under the AICPA Code of Professional Ethics you cannot give advice on management advisory service areas at the same time you are doing an audit.
b. Explain that under the AICPA Statement on Management Advisory Services informal advice of this type is prohibited.
c. Respond with definite recommendations based on your audit of these records but state that you will not assume any responsibility for any changes unless your specific recommendations are followed.
d. Respond as practicable at the moment and express the basis for your response so it will be accepted for what it is.

42. You are a CPA retained by the manager of a cooperative retirement village to do "write-up work." You are expected to prepare unaudited financial statements with each page marked "unaudited" and accompanied by a disclaimer of opinion stating no audit was made. In performing the work you discover that there are no invoices to support \$25,000 of the manager's claimed disbursements. The manager informs you that all the disbursements are proper. What should you do?

a. Submit the expected statements but omit the \$25,000 of unsupported disbursements.
b. Include the unsupported disbursements in the statements since you are not expected to make an audit.
c. Obtain from the manager a written statement that you informed him of the missing invoices and his assurance that the disbursements are proper.
d. Notify the owners that some of the claimed disbursements are unsupported and withdraw if the situation is not satisfactorily resolved.

43. As part of your annual audit of a client, you prepare the federal income tax return. What modifications, if any, should you make to the preparer's declaration when signing the return?

a. You should make no modification.
b. You should modify the declaration to conform with the wording of your audit report.
c. You should add a sentence to the declaration that the information contained herein was taken from audited financial statements covered by your report dated ______________.
d. You should add a sentence to the declaration that some of the information contained herein was furnished by the client without audit.

44. Which of the following is the **least** important consideration when an auditor is deciding whether he can act as principal auditor for consolidated financial statements and utilize the work and reports of other independent auditors?

a. Whether the portion of the financial statements he has examined is material compared with the portion examined by other auditors.
b. Whether the components he examined are important relative to the enterprise as a whole.
c. Whether he has examined the parent company statements.
d. Whether he has sufficient knowledge of the overall financial statements.

45. Abbot, CPA, as principal auditor for consolidated financial statements is using a qualified report of another auditor. Abbot does **not** consider the qualification material relative to the consolidated financial statements. What recognition, if any, must Abbot make in his report to the report of the other audit?

a. He need make no reference.
b. He must refer to the qualification of the other auditor and qualify his report likewise.
c. He must include the other auditor's report with his report but need not qualify his report.
d. He must include the other auditor's report with his report and give an explanation of its significance.

46. Under the AICPA Code of Professional Ethics a CPA may issue an unqualified opinion on financial statements which contain a departure from generally accepted accounting principles if he can demonstrate that due to unusual circumstances the financial statements would be misleading if the departure were not made. Which of the following is an example of unusual circumstances which could justify such a departure?

a. New legislation.
b. An unusual degree of materiality.
c. Conflicting industry practices.
d. A theoretical disagreement with a standard promulgated by the Financial Accounting Standards Board.

47. Adams, CPA, is preparing a federal tax return for Evans. In an interview to gather the necessary data, Evans stated he had given about $100 to charitable organizations soliciting at the door such as the local volunteer fire department and March of Dimes. What should Adams do with this information when preparing the tax return?

a. He should ignore it because Statements on Responsibility in Tax Practice issued by the AICPA prohibit the use of estimates.
b. He should identify $100 as "Other miscellaneous contributions."
c. He should identify as contributions "volunteer fire department – $50 and March of Dimes – $50."
d. He should increase one of Evan's other specifically named contributions by $100.

48. The AICPA Committee on Management Services has stated its belief that a CPA should **not** undertake a management advisory service engagement for implementation of the CPA's recommendations unless

a. The client does not understand the nature and implications of the recommended course of action.
b. The client has made a firm decision to proceed with implementation based on his complete understanding and consideration of alternatives.
c. The client does not have sufficient expertise within his organization to comprehend the significance of the changes being made.
d. The CPA withdraws as independent auditor for the client.

49. Russo, CPA, succeeded Brown, CPA, as auditor of Sunshine Corp. for the calendar year 1974. Brown had issued an unqualified report for the calendar year 1973. What must Russo do to establish the basis for expressing his opinion on the financial statements with regard to opening balances?

a. Russo must apply appropriate auditing procedures to all account balances at the beginning of the period so as to satisfy himself that they are properly stated and may not rely on any work done by Brown.
b. Russo may review Brown's work papers and thereby reduce the scope of audit tests he would otherwise have to do.
c. Russo may rely on the prior year's financial statements since an unqualified opinion was issued but should not make reference in his report to Brown's report.
d. Russo may rely on the prior year's financial statements since an unqualified opinion was issued but must refer in a middle paragraph of his report to Brown's report of the prior year.

50. According to court decisions, the generally accepted auditing standards established by the AICPA apply

a. Only to the AICPA membership.
b. To all CPAs.
c. Only to those who choose to follow them.
d. Only when conducting audits subject to AICPA jurisdiction.

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

The third generally accepted auditing standard of field work requires that the auditor obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements under examination. In considering what constitutes sufficient competent evidential matter, a distinction should be made between underlying accounting data and all corroborating information available to the auditor.

Required:

a. Discuss the nature of evidential matter to be considered by the auditor in terms of the underlying accounting data, all corroborating information available to the auditor, and the methods by which the auditor tests or gathers competent evidential matter.

b. State the three general presumptions that can be made about the validity of evidential matter with respect to comparative assurance, persuasiveness, and reliability.

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

Gilbert and Bradley formed a corporation called Financial Services, Inc., each man taking 50 percent of the authorized common stock. Gilbert is a CPA and a member of the American Institute of CPAs. Bradley is a CPCU (Chartered Property Casualty Underwriter). The Corporation performs auditing and tax services under Gilbert's direction and insurance services under Bradley's supervision. The opening of the corporation's office was announced by a three-inch, two-column "card" in the local newspaper.

One of the corporation's first audit clients was the Grandtime Company. Grandtime had total assets of $600,000 and total liabilities of $270,000. In the course of his examination, Gilbert found that Grandtime's building with a book value of $240,000 was pledged as security for a ten-year-term note in the amount of $200,000. The client's statements did not mention that the building was pledged as security for the ten-year-term note. However, as the failure to disclose the lien did not affect either the value of the assets or the amount of the liabilities and his examination was satisfactory in all other respects, Gilbert rendered an unqualified opinion on Grandtime's financial statements. About two months after the date of his opinion, Gilbert learned that an insurance company was planning to loan Grandtime $150,000 in the form of a first-mortgage note on the building. Realizing that the insurance company was unaware of the existing lien on the building, Gilbert had Bradley notify the insurance company of the fact that Grandtime's building was pledged as security for the term note.

Shortly after the events described above, Gilbert was charged with a violation of professional ethics.

Required:

Identify and discusss the ethical implications of those acts by Gilbert that were in violation of the AICPA Code of Professional Ethics.

Number 5 (Estimated time –– 20 to 30 minutes)

Arthur, CPA, is auditing the RCT Manufacturing Company as of February 28, 1975. As with all engagements, one of Arthur's initial procedures is to make overall checks of the client's financial data by reviewing significant ratios and trends so that he has a better understanding of the business and can determine where to concentrate his audit efforts.

The financial statements prepared by the client with audited 1974 figures and preliminary 1975 figures are presented below in condensed form.

RCT Manufacturing Company
CONDENSED BALANCE SHEETS
February 28, 1975 and 1974

Assets	*1975*	*1974*
Cash	$ 12,000	$ 15,000
Accounts receivable, net	93,000	50,000
Inventory	72,000	67,000
Other current assets	5,000	6,000
Plant and equipment, net of depreciation	60,000	80,000
	$242,000	$218,000

Equities		
Accounts payable	$ 38,000	$ 41,000
Federal income tax payable	30,000	14,400
Long-term liabilities	20,000	40,000
Common stock	70,000	70,000
Retained earnings	84,000	52,600
	$242,000	$218,000

RCT Manufacturing Company
CONDENSED INCOME STATEMENTS
Years Ended February 28, 1975 and 1974

	1975	*1974*
Net sales	$1,684,000	$1,250,000
Cost of goods sold	927,000	710,000
Gross margin on sales	757,000	540,000
Selling and administrative expenses	682,000	504,000
Income before federal income taxes	75,000	36,000
Income tax expense	30,000	14,400
Net income	$ 45,000	$ 21,600

Additional information:

- The company has only an insignificant amount of cash sales.
- The end of year figures are comparable to the average for each respective year.

Required:

For each year compute the current ratio and a turnover ratio for accounts receivable. Based on these ratios, identify and discuss audit procedures that should be included in Arthur's audit of (1) accounts receivable and (2) accounts payable.

Number 6 (Estimated time –– 20 to 25 minutes)

In connection with the annual examination of Johnson Corp., a manufacturer of janitorial supplies, you have been assigned to audit the fixed assets. The company maintains a detailed property ledger for all fixed assets. You prepared an audit program for the balances of property, plant, and equipment but have yet to prepare one for accumulated depreciation and depreciation expense.

Required:

Prepare a separate comprehensive audit program for the accumulated depreciation and depreciation expense accounts.

Number 7 (Estimated time -- 20 to 25 minutes)

Various types of "accounting changes" can affect the second reporting standard of the generally accepted auditing standards. This standard reads, "The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period."

Assume that the following list describes changes which have a material effect on a client's financial statements for the current year.

1. A change from the completed-contract method to the percentage-of-completion method of accounting for long-term construction-type contracts.
2. A change in the estimated useful life of previously recorded fixed assets based on newly acquired information.
3. Correction of a mathematical error in inventory pricing made in a prior period.
4. A change from prime costing to full absorption costing for inventory valuation.
5. A change from presentation of statements of individual companies to presentation of consolidated statements.
6. A change from deferring and amortizing pre-production costs to recording such costs as an expense when incurred because future benefits of the costs have become doubtful. The new accounting method was adopted in recognition of the change in estimated future benefits.
7. A change to including the employer share of FICA taxes as "Retirement benefits" on the income statement from including it with "Other taxes."
8. A change from the FIFO method of inventory pricing to the LIFO method of inventory pricing.

Required:

Identify the type of change which is described in each item above, state whether any modification is required in the auditor's report **as it relates to the second standard of reporting,** and state whether the prior year's financial statements should be restated when presented in comparative form with the current year's statements. Organize your answer sheet as shown below.

For example a change from the LIFO method of inventory pricing to the FIFO method of inventory pricing would appear as shown.

Item No.	*Type of Change*	*Should Auditor's Report be Modified?*	*Should Prior Year's Statements be Restated?*
Example	An accounting change from one generally accepted accounting principle to another generally accepted accounting principle.	Yes	Yes

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN BUSINESS LAW

(Commercial Law)

May 9, 1975; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	25	30
No. 2	25	30
No. 3	25	30
No. 4	25	30
No. 5	25	30
No. 6	25	30
No. 7	25	30
Total for examination	175	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered from 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The text of a letter from Bridge Builders, Inc., to Allied Steel Co. follows:

> We offer to purchase 10,000 tons of No. 4 steel pipes at today's quoted price for delivery two months from today. Your acceptance must be received in five days.

What type of contract did Bridge Builders intend to create?

a. Express.
b. Unilateral.
c. Bilateral.
d. Joint.

Answer Sheet

99. a. :::::::::: b. :::::::::: c. ▬▬▬▬ d. ::::::::::

Items to be Answered

1. In the event the purchaser seeks to rescind a contract for the purchase of land because of the seller's misrepresentation (as contrasted with seeking damages for the tort of fraud), the plaintiff (purchaser)
   a. Need **not** show knowledge of falsity on the defendant's part (seller) in order to recover.
   b. Need **not** show reliance upon the misrepresentation on his part in order to recover.
   c. Can resort to the Statute of Frauds in order to obtain a rescission on the contract.
   d. Will prevail only if there was misrepresentation in the execution which renders the contract void.

2. A contract for the purchase and sale of real property
   a. Must be signed by both parties in order to be binding on either.
   b. Must be contained in a formalized, signed, and notarized document if the contract is to be enforceable.
   c. Is **not** assignable unless specifically authorized in the contract.
   d. Contains an implied promise that the title to the property to be conveyed is marketable.

Items 3 and 4 are based on the following information:

Matson loaned Donalds $1,000 at 8% interest for one year. Two weeks before the due date, Matson called upon Donalds and obtained his agreement in writing to modify the terms of the loan. It was agreed that on the due date Donalds would pay $850 to Cranston, to whom Matson owed that amount, and pay the balance plus interest to his son, Arthur, to whom he wished to make a gift.

3. Which of the following statements is legally valid with respect to the events described above?
   a. Because Matson never received the interest on the Donalds loan, he will **not** have to include it in his gross income for federal income tax purposes.
   b. Matson has irrevocably assigned the debt to Cranston and Arthur.
   c. In the event of default by Donalds, Cranston must first proceed against him before seeking recourse against Matson.
   d. Neither of the agreements between Matson and Donalds needs to be in writing.

4. Under the modified terms of the loan, Cranston and/or Arthur have what legal standing?
   a. Cranston is a creditor beneficiary and Arthur is a donee beneficiary.
   b. Cranston has the right to prevent Matson's delegation if he gives timely notice.
   c. If Cranston is to be able to proceed against Donalds, he must have received notice of Donalds' promise to pay him the $850 prior to the due date.
   d. Arthur is an incidental beneficiary.

---

5. Fox, Harrison, and Dodge are the general partners of Great Expectations, a limited partnership. There are 20 limited partners. The general partners wish to add two more general partners and sell additional limited partnership interests to the public. The limited partnership certificate is silent on these matters. The general partners
   a. Can admit the two additional partners as general partners without the consent of the limited partners if the general partners vote unanimously to do so.
   b. **Cannot** admit additional limited partners unless there is unanimous written consent or ratification of their action by the limited partners.
   c. Can admit additional limited partners if a majority of the general and limited partners consent to do so.
   d. **Cannot** admit any general or limited partners without amending the written partnership agreement.

6. Gregor paid $100 to Henry for a thirty-day written option to purchase Henry's commercial real property for $75,000. Twenty days later Henry received an offer from Watson to purchase the property for $85,000. Henry promptly notified Gregor that the option price was now $85,000, or the option was revoked. Gregor said he would not pay a penny more than $75,000 and that he still had 10 days remaining on the option. On the 28th day of the option Gregor telephoned Henry that he had decided to exercise the option; he tendered his $75,000 check the next day which was to be held in escrow until delivery of the deed. Henry refused to accept the tender stating that he had decided **not** to sell and that he was going to retain the property for the present. Which of the following **best** describes the legal rights of the parties involved?
   a. Henry effectively revoked his offer to sell because he did this prior to Gregor's acceptance.
   b. Consideration given for the option is irrelevant because the option was in writing and signed by Henry.
   c. Because Gregor's acceptance was **not** in writing and signed, it is invalid according to the Statute of Frauds.
   d. Gregor's acceptance was valid, and in the event of default he may obtain the equitable remedy of specific performance.

7. Martinson Services, Inc., agreed to rent two floors of office space in Jason's building for five years. An escalation clause in the lease provided for a $200 per month increase in rental in the fifth year of occupancy by Martinson. Near the end of the fourth year, during a serious economic recession, Martinson's business was doing very poorly. Martinson called upon Jason to inform him that Martinson could **not** honor the lease if the rent was increased in the fifth year. Jason agreed in a signed writing to allow Martinson to remain at the prior rental, and Martinson did so. At the end of the fifth year Martinson moved to another office building. Then, Jason demanded payment of $2,400 from Martinson.

What is the legal standing of the parties involved?
   a. A binding accord and satisfaction has resulted between the parties.
   b. The agreed upon rent reduction is valid due to the increased burden of performance as a result of events beyond Martinson's control.
   c. Martinson's relinquishment of the legal right to breach the contract provides the consideration for the reduction in rent.
   d. The writing signed by Jason does not bind him to the agreed reduction in rent.

8. Franklin's will left his ranch "to his wife, Joan, for her life, and upon her death to his sons, George and Harry, as joint tenants." Because of the provisions in Franklin's will
   a. Joan **cannot** convey her interest in the ranch except to George and Harry.
   b. The ranch must be included in Joan's estate for federal estate tax purposes upon her death.
   c. If George predeceases Harry, Harry will obtain all right, title, and interest in the ranch.
   d. Joan holds the ranch in trust for the benefit of George and Harry.

9. Higgins contracted to pay $3,500 to Clark for $4,000 of thirty-day accounts receivables that arose in the course of Clark's office equipment leasing business. Higgins subsequently paid the $3,500. What is the legal status of this contract?
   a. The contract is within the Statute of Frauds.
   b. If Higgins failed to notify the debtors whose accounts were purchased, they will, upon payment in good faith to Clark, have **no** liability to Higgins.
   c. The contract in question is illegal because it violates the usury laws.
   d. Higgins will be able to collect against the debtors free of the usual defenses which would be assertible against Clark, e.g., breach of contract.

10. Barnes agreed to purchase from Damion 1,000 shares of Excelsior Photo, Inc., stock at $100 per share. Barnes was interested in obtaining control of Excelsior, whose stock was very closely held. The stock purchase agreement contained the following clause: "This contract is subject to my (Barnes') obtaining more than 50% of the shares outstanding of Excelsior Photo stock." In this situation
   a. The contract is **not** binding on Damion because it lacks consideration on Barnes' part, i. e., unless he obtained more than 50%, he is **not** liable.
   b. The contract is subject to an express condition precedent.
   c. Specific performance would **not** be available to Barnes if Damion refuses to perform.
   d. While the contract is executory, Damion **cannot** transfer good title to a third party who takes in good faith.

11. Unlimited Fashions, Inc., leased a store in the Suburban Styles Shopping Center for five years at $1,500 a month. The lease contained a provision which prohibited assignment of the lease. After occupying the premises for two years, Unlimited sublet the premises to Fantastic Frocks for the balance of its term, less one day, at $2,000 per month. Unlimited moved out on a Sunday and removed all its personal property and trade fixtures such as portable clothing racks, cash registers, detachable counters, etc. Which of the following **best** describes the legal status of the parties involved?
   a. Unlimited has **not** breached its contract with Suburban.
   b. Suburban is entitled to the additional $500 rental paid each month by Fantastic to Unlimited.
   c. Removal of the trade fixtures in question by Unlimited was improper and it can be held liable to Suburban for their fair value.
   d. Fantastic is a tenant of Suburban.

12. Norton owned and operated a trucking business. He was financially hard pressed and obtained a loan from the First State Bank "secured by his equipment and including all other chattels and personal property used in his business." The loan security agreement was properly filed in the county records office. In addition, Norton obtained a loan from the Title Mortgage Company; the loan was secured by a first mortgage on all the real property used in the trucking business. Norton is now insolvent and a petition in bankruptcy has been filed. Which of the following is a correct statement concerning the security interests in the properties?

a. If Title Mortgage failed to record its mortgage, the trustee in bankruptcy will be able to defeat Title's security interest.
b. Norton's central air conditioning and heating system is included in First State's security interest.
c. If Title Mortgage did **not** record its mortgage, First State is entitled to all fixtures, including those permanently annexed to the land.
d. A sale of all the personal and real business property by Norton to a bona fide purchaser will defeat First State's security interest unless First State recorded its security interest in both the appropriate real and personal property recordation offices.

13. Lutz sold his moving and warehouse business, including all the personal and real property used therein, to Allen Van Lines, Inc. The real property was encumbered by a $300,000 first mortgage upon which Lutz was personally liable. Allen acquired the property subject to the mortgage. Two years later, when the mortgage outstanding was $260,000, Allen decided to abandon the business location because it had become unprofitable and the value of the real property was less than the outstanding mortgage. Allen moved to another location and refused to pay the installments due on the mortgage. What is the legal status of the parties in regard to the mortgage?

a. Allen took the real property free of the mortgage.
b. Allen breached its contract with Lutz when it abandoned the location and defaulted on the mortgage.
c. Lutz must satisfy the mortgage debt in the event that foreclosure yields an amount less than the unpaid balance.
d. If Lutz pays off the mortgage, he will be able to successfully sue Allen because Lutz is subrogated to the mortgagee's rights against Allen.

14. An exemption from the full registration requirements under federal securities law is generally accorded those offerings by an issuer whose aggregate offering price during any twelve-month period

a. Does **not** exeed $90,000.
b. Does **not** exceed $300,000.
c. Does **not** exceed $500,000.
d. Does **not** exceed 10 percent of the value of the issuer's securities then outstanding.

15. Issuer, Inc., a New York corporation engaged in retail sales within New York City, was interested in raising $1,000,000 in capital. In this connection it approached through personal letters eighty-eight people in New York, New Jersey, and Connecticut, and then followed up with face-to-face negotiations where it seemed promising to do so. After extensive efforts in which Issuer disclosed all the information that these people requested, nineteen people from these areas purchased Issuer's securities. Issuer did **not** limit its offers to insiders, their relatives, or wealthy or sophisticated investors. In regard to this securities issuance,

a. The offering is probably exempt from registration under federal securities law as a private placement.
b. The offering is probably exempt from registration under federal securities law as a small offering.
c. The offering is probably exempt from registration under federal securities law as an intrastate offering.
d. The offering probably is **not** exempt from registration under federal securities law.

16. Mr. Jackson owns approximately 40% of the shares of common stock of Triad Corporation. The rest of the shares are widely distributed among over 2,000 shareholders. Jackson has had a number of personal problems related to other business ventures and would like to raise about $2,000,000 through the sale of some of his shares. He accordingly approached Underwood & Sons, an investment banking house in which he knew one of the principals, to purchase his Triad shares and distribute the shares to the public at a reasonable price through its offices in the United States. Any profit on the sales could be retained by Underwood pursuant to an agreement reached between Jackson and Underwood. In this situation

a. The securities to be sold probably do **not** need to be registered with the Securities and Exchange Commission.
b. Underwood & Sons probably is **not** an underwriter as defined in the federal securities law.
c. Jackson probably is considered the issuer under federal securities law.
d. Under federal securities law, **no** prospectus is required to be filed in connection with this contemplated transaction.

Number 2 (Estimated time -- 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

17. Harrison purchased Bigacre from Whitmore. The deed described the real property conveyed and the granting clause read: "Seller hereby releases, surrenders, and relinquishes to buyer any right, title, or interest that he may have in Bigacre." The deed contained no covenants. What is Harrison's legal status concerning title to Bigacre?
   a. Harrison has obtained a quitclaim deed.
   b. If an adverse claimant ousts Harrison from Bigacre, Harrison will have recourse against Whitmore.
   c. The only warranty contained in the deed is an implied warranty of marketability of title.
   d. Harrison's deed is neither insurable nor recordable.

18. Martin Cosgrove induced Harold Watts, Charles Randall, and James Howard to join him in a partnership venture. Cosgrove is a sophisticated investor. He proposed that Watts, Randall, and Howard each contribute $100,000 cash to a limited partnership which would consist of himself as general partner and the others as limited partners. Cosgrove was to contribute $50,000, but he was to share equally in all profits and assume all losses in excess of $50,000 upon dissolution. Under these circumstances
   a. The purported creation of a limited partnership is invalid because there must be at least two general partners.
   b. Creditors of the limited partnership would have to sue Cosgrove for any deficiency of assets in liquidation in excess of $50,000 before being able to resort to limited-partnership property above this amount.
   c. If one of the limited partners agreed in the certificate to contribute $100,000 cash but instead contributed $90,000 in cash and $10,000 in services, he may be held liable to the partnership creditors for $10,000.
   d. The limited partnership can properly be called the Cosgrove, Watts, Randall & Howard Investing Company, Limited Partnership.

19. Kimball, Thompson, and Darby formed a partnership. Kimball contributed $25,000 in capital and loaned the partnership $20,000; he performed no services. Thompson contributed $15,000 in capital and part-time services, and Darby contributed only his full-time services. The partnership agreement provided that all profits and losses would be shared equally. Three years after the formation of the partnership, the three partners agreed to dissolve and liquidate the partnership. Firm creditors, other than Kimball, have bona fide claims of $65,000. After all profits and losses have been recorded there are $176,000 of assets to be distributed to creditors and partners. When the assets are distributed
   a. Darby receives nothing since he did **not** contribute any property.
   b. Thompson receives $45,333 in total.
   c. Kimball receives $62,000 in total.
   d. Each partner receives one-third of the remaining assets after all the firm creditors, including Kimball, have been paid.

20. Bonanza Real Estate Ventures is a limited partnership created pursuant to the law of a state which has adopted the Uniform Limited Partnership Act. It has three general partners and 1,100 limited partners living in various states. The limited partnership interests were offered to the general public at $5,000 per partnership interest. Johnson purchased a limited-partnership interest in the Bonanza Real Estate Ventures. As such, he
   a. **Cannot** assign his limited-partnership interest to another person without the consent of the general partners.
   b. Is entitled to interest on his capital contribution.
   c. Is a fiduciary vis-a-vis the limited partnership and its partners.
   d. Must include his share of the limited-partnership taxable profits in his taxable income even if he does **not** withdraw anything.

21. Donald Fisk is a limited partner of Sparta Oil Development. He paid $10,000 for his limited-partnership interest. In addition, he loaned Sparta $7,500. Sparta failed to find oil and is in financial difficulty. Upon dissolution and liquidation,
   a. Donald Fisk will receive repayment of his loan only after all outside general creditors have first been satisfied, but prior to any other distributions.
   b. Donald Fisk will receive repayment, along with the other limited partners, in respect to his capital and loan after all other creditors have been satisfied.
   c. The last item to be distributed, if anything remains, is to the general partners in respect to profits.
   d. If Donald Fisk holds partnership property as collateral, he may resort to it to satisfy any deficiency if partnership assets are insufficient to meet creditors' claims.

22. Filmore hired Stillwell as his agent to acquire Dobbs' land at a price **not** to exceed $50,000; the land is badly needed to provide additional parking space for Filmore's shopping center. In order to prevent Dobbs from asking for an exorbitant price, Filmore told Stillwell **not** to disclose his principal. Stillwell subsequently purchased the land for $45,000. Under these circumstances
   a. Stillwell and Filmore committed fraud when they did **not** disclose the fact that Stillwell was Filmore's agent.
   b. Absent an agreement regarding the compensation to be paid Stillwell, he is entitled to the difference between the $50,000 limitation and the $45,000 he paid for the land; i.e., $5,000 based upon quasi contract.
   c. Dobbs may rescind the contract upon his learning the truth as long as the conveyance has **not** been accomplished.
   d. Dobbs may sue either Filmore or Stillwell on the contract in the event of default by Filmore.

23. The partnership of Baker, Green, and Madison is insolvent. The partnership's liabilities exceed its assets by $123,000. The liabilities include a $25,000 loan from Madison. Green is personally insolvent, his personal liabilities exceed his personal assets by $13,500. Green has filed a voluntary petition in bankruptcy. Under these circumstances, partnership creditors
   a. Must proceed jointly against the partnership and all the general partners so that losses may be shared equitably among the partners.
   b. Rank first in payment and all (including Madison) will share proportionately in the partnership assets to be distributed.
   c. Will have the first claim to partnership property to the exclusion of the personal creditors of Green.
   d. Have the right to share pro rata with Green's personal creditors Green's personal assets.

24. Jack Gordon, a general partner of Visions Unlimited, is retiring. He sold his partnership interest to Don Morrison for $80,000. Gordon assigned to Morrison all his rights, title, and interests in the partnership and named Morrison as his successor partner in Visions. In this situation
   a. The assignment to Morrison dissolves the partnership.
   b. Absent any limitation regarding the assignment of a partner's interest, Gordon is free to assign it at his will.
   c. Morrison is entitled to an equal voice and vote in the management of the partnership, and he is entitled to exercise all the rights and privileges that Gordon had.
   d. Morrison does **not** have the status of a partner, but he can, upon demand, inspect the partnership accounting records.

25. Morton, a senior staff member of Wilcox & Southern, CPAs, has been offered the opportunity to become a junior partner of the firm. However, to be admitted to the partnership he must contribute $30,000 to the partnership's capital, and he does not have that amount of money. It is estimated that the partnership interest in question is worth at least $100,000. The partnership agreement is silent on assignment of a partner's interest. Morton accepts the offer and becomes a junior partner.
   a. Morton could assign his partnership interest to a bank or other lending institution as security for a loan to acquire his partnership interest.
   b. Morton is personally liable for all debts of the partnership, past and present, unless the partnership agreement provides otherwise.
   c. Since Morton is only a junior partner with very little say in the management of the firm and the selection of clients, he has the legal status of a quasi limited partner.
   d. If Morton pledged his partnership interest as security for a loan to acquire his partnership interest, the transaction created a sub-partnership between himself and the lending institution.

26. Menlow Corporation dismissed Gibson, its purchasing agent, for incompetence. It published a notice in the appropriate trade journals which stated: "This is to notify all parties concerned that Gibson is no longer employed by the Menlow Corporation and the corporation assumes **no** further responsibility for his acts." Gibson called on several of Menlow's suppliers with whom he had previously dealt, and when he found one who was unaware of his dismissal, he would place a substantial order for merchandise to be delivered to a warehouse in which he had rented space. Menlow had rented warehouse space in the past when its storage facilities were crowded. Gibson also called on several suppliers with whom Menlow had never dealt; he would present one of his old business cards to the secretary and then make purchases on open account in the name of Menlow. Gibson then sold all the merchandise delivered to the warehouse and absconded with the money. In this situation,
   a. Gibson had continuing express authority to make contracts on Menlow's behalf with suppliers with whom he had previously dealt as Menlow's agent, if they were unaware of his dismissal.
   b. The suppliers who previously had **no** dealings with Menlow **cannot** enforce the contracts against Menlow even if the suppliers were unaware of Gibson's lack of authority.
   c. Menlow is liable on the Gibson contracts to all suppliers who had dealt with Gibson in the past as Menlow's agent.
   d. Constructive notice via publication in the appropriate trade journals is an effective notice to all third parties regardless of whether they had dealt with Gibson or read the notice.

27. Head is a crane operator for Magnum Construction Corporation. One day while operating the crane he negligently swung the crane into another building, which caused extensive damage to the other building and the crane. The accident also resulted in fracturing Head's elbow and dislocating his hip. In this situation,
   a. Head is liable for the damages he caused to the crane and the building.
   b. Magnum's liability is limited to the damage to the building only if Head was acting within the scope of his authority.
   c. Magnum will **not** be liable for damage to the building if Head's negligence was in clear violation of Magnum's safety standards and rules regarding operation of the crane.
   d. Head is **not** entitled to workmen's compensation.

28. An agency relationship
   a. Must be in writing if it is to be legally enforceable.
   b. Creates a fiduciary duty on the principal's part.
   c. Can be created by estoppel, i.e., implied as a matter of law.
   d. Is normally delegatable as a matter of law.

29. Charles Wilson and Donald Black decided to merge their competing business proprietorships. The resulting partnership was established by a mere handshake. The oral partnership agreement did **not** cover profit sharing or salaries. For this partnership,
   a. The federal antitrust laws do **not** apply.
   b. The Statute of Frauds does **not** require Wilson and Black's agreement to be in writing.
   c. The partnership is voidable by the creditors of either proprietorship.
   d. Wilson is entitled to a reasonable salary for his services as managing partner.

30. The ratification doctrine
   a. Is **not** applicable to situations where the party claiming to act as the agent for another has **no** express or implied authority to do so.
   b. Is designed to apply to situations where the principal was originally incompetent to have made the contract himself, but who, upon becoming competent, ratifies.
   c. Requires the principal to ratify the entire act of the agent and the ratification is retroactive.
   d. Applies only if the principal expressly ratifies in writing the contract made on his behalf within a reasonable time.

31. Normally a principal will **not** be liable to a third party
   a. On a contract signed on his behalf by an agent who was expressly forbidden by the principal to make it and where the third party was unaware of the agent's limitation.
   b. On a contract made by his agent and the principal is **not** disclosed, unless the principal ratifies it.
   c. For torts committed by an independent contractor if they are within the scope of the contract.
   d. On a negotiable instrument signed by the agent in his own name without revealing he signed in his agency capacity.

32. Digital Sales, Inc., leased office space from Franklin Rentals for a five-year period. The lease did **not** contain any provisions regarding insurance by the lessee. During the term of the lease the office building was gutted by a fire that started in an adjacent building and spread to Franklin's building. In this situation
   a. Digital has an implied obligation to insure the portion of the building it leased, to protect its interest in the property and that of the lessor.
   b. Digital has an insurable interest in the building, but only to the extent of the value of its leasehold.
   c. If the building is fully occupied and leased on long-term leaseholds, Franklin has **no** insurable interest.
   d. If Franklin sold the building, it could nevertheless continue the insurance coverage and collect on the policy because its insurable interest in the building runs from its prior ownership.

Number 3 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

33. Cutler sent Foster the following offer by mail:

> I offer you 150 Rex portable electric typewriters, model J-1 at \$65 per typewriter, FOB your truck at my warehouse; terms 2/10, net/30. I am closing out this model, hence the substantial discount. Accept all or none.
>
> (signed) Cutler

Foster immediately wired back:

> I accept your offer re the Rex electric typewriters, but will use Red Ball Express Company for the pickup, at my expense of course. In addition, if possible, could you have the shipment ready by Tuesday at 10:00 AM because of the holidays?
>
> (signed) Foster

   a. The purported acceptance is invalid since it states both additional and different terms than those contained in the offer.
   b. A purported acceptance which ordered 50 Rex electric typewriters would be valid.
   c. Assuming the acceptance to be valid, it will **not** be effective until received by Cutler.
   d. A purported acceptance which read, "Shipment must be ready by Tuesday at 10:00 AM or forget it." would constitute a counteroffer.

34. Carter purchased goods from Dunn for \$450. Dunn orally made an express warranty of fitness of the goods for the particular purpose described by Carter. In addition, Dunn orally disclaimed "all warranty protection." The express warranty of fitness
   a. Is irrelevant in any event, because it is superceded by the Uniform Commercial Code section which creates an implied warranty of fitness.
   b. Is valid even though **not** in writing.
   c. Is effectively negated by the general disclaimer clause assuming both the warranty and disclaimer are in writing.
   d. Coupled with the disclaimer, effectively negates all Carter's implied warranty protection.

35. Workmen's compensation laws
    a. Are uniform throughout the United States with the exception of Louisiana.
    b. Have **not** been adopted by all states except where required by federal law.
    c. Do **not** preclude an action against a third party who has caused an injury.
    d. Do **not** cover employees injured outside the jurisdiction.

Items 36 and 37 are based on the following information:

On February 1, 1975, Barron Explosives received an order from Super Construction, Inc., for 200 cases of dynamite at $25 per case with terms of 2/10, net/30, for delivery within two months, FOB seller's warehouse. The order was duly accepted in writing by Barron. Super soon discovered that it was already overstocked with dynamite and, therefore, it contacted Chubb Construction Company to see if it would be interested in taking over the contract. Chubb Construction Company indicated it would take over the contract and signed the following agreement on February 10, 1975:

> Super Construction, Inc., hereby assigns its contract for the purchase of 200 cases of dynamite at $25 per case ordered from Barron Explosives on February 1, 1975, to Chubb Construction Company. Chubb Construction hereby accepts.
>
> (Signed) Super, President
> Super Construction, Inc.
>
> (Signed) Chubb, President
> Chubb Construction Company

Since February 1, 1975, the price of dynamite has increased substantially, and as a result, Super wishes to avoid the assignment and obtain the dynamite for itself. Barron wishes to avoid having to deliver to either party.

36. Which of the following statements **best** describes the legal status of the parties to the contract?
    a. Barron can avoid its obligation on the contract if it has reasonable grounds for insecurity because Chubb's credit rating is inferior to that of Super's.
    b. The assignment in question transfers to Chubb both the rights and the duties under the contract.
    c. Super can avoid the assignment to Chubb based upon the fact that it is lacking in consideration on Chubb's part.
    d. The contract is **not** assignable because it would materially vary Barron's duty to perform.

37. Assume that instead of Super Construction assigning the contract Barron Explosives found that it could **not** perform, and therefore, it assigned the contract to a nearby competitor, Demerest Explosives. Demerest promised Barron it would perform on the Super contract and expressly released Barron from any responsibility. Demerest subsequently defaulted and has refused to deliver.
    a. Barron's delegation of its duty to perform to Demerest Explosives constitutes an anticipatory breach of contract.
    b. Super Construction need **not** perform since the assignment of the contract materially alters its burden of performing.
    c. Super Construction can immediately proceed against Barron upon default by Demerest.
    d. Super Construction has recourse only against Barron.

---

38. Haworth Discount Stores mailed its order to Eagle Recordings, Inc., for 100 eight-track cassette recordings of "Swan Songs" by the Paginations at $5.50 per cassette. Eagle promptly wired its acceptance, delivery to take place within two weeks from date of Haworth's order and terms of net 30 days. Before delivery was made by Eagle, the retail price of this recording by the Paginations fell to $4.95. Haworth Discount informed Eagle of this and pleaded with Eagle, "Because we have been good customers give us a break by either reducing the price to $4.95 so we can break-even or by allowing us to cancel the order." Eagle's sales manager called Haworth the next day and informed them that the price would be $4.95 per cassette, **not** the price that appeared on the original invoice.

The modification of the initial Haworth-Eagle contract
    a. Fails due to lack of consideration.
    b. Need **not** satisfy the Statute of Frauds.
    c. Must be written and signed by the parties to be valid if **no** consideration is given by the party seeking to rely upon the modification.
    d. Is voidable by Eagle at any time prior to shipment of the 100 cassettes.

39. A merchant made the following offer: "I offer you 100 cases of No. 3 macaroni at $13.50 per case. This offer is irrevocable for ten days." In which of the following situations would the offer be irrevocable because it is a "firm offer" or option contract under the Uniform Commercial Code?
    a. The offer was made orally and admitted to in court by the seller.
    b. The offer was written and signed by the seller.
    c. The offer was written and signed by the seller, but the second sentence read: "Acceptance must be made within ten days."
    d. Like all previous contracts for macaroni between the offeror and offeree, the offer was made by telephone.

40. Marvin purchased a new 1975 automobile from Excellent Auto Sales. The car was fully warranted by the manufacturer, Specific Motors, for one year or 20,000 miles whichever occurred sooner. There was **no** warranty disclaimer by either the manufacturer or the retailer. The car contained a hidden defect insofar as the retailer was concerned, i.e., one that could **not** be discovered with reasonable care except during manufacture. The defect caused Marvin to have a serious accident which damaged the car and injured him. Which of the following statements is true regarding the status of Marvin's contract?

a. Marvin is **not** in privity of contract with Specific Motors.
b. Excellent Auto has **no** liability to Marvin in that it could **not** have discovered the defect.
c. The Uniform Commercial Code abolished the privity requirement in cases such as this.
d. Marvin may recover only for the damage to the car and the replacement of the defective parts.

41. Visco Sales, Inc., sent Nails Manufacturing Corporation the following telegram:

> We need 2,000 two-pound boxes of your best grade two-inch roofing nails. Ship at once.
>
> Visco Sales, S. Peters,
> V.P. of Purchasing

a. The telegram is too indefinite and uncertain to constitute an offer.
b. Acceptance by Nails will **not** take place until receipt of the shipment by Visco.
c. The telegram is **not** an offer, but a mere invitation to do business.
d. The telegram constitutes a signed writing which would be enforceable against Visco under the Statute of Frauds, assuming the nails would cost $500 or more.

42. Carter Corporation loaned $500,000 to Devon Corporation pursuant to an oral agreement granting a security interest in certain shares of stock held by Devon. Carter sought to have Devon sign a security agreement granting a security interest in the shares. Devon refused to sign any agreement, but instead delivered the stock certificates in question to Carter.

a. The security interest of Carter is **not** perfected until Devon signs the security agreement or Carter files a financing statement, whichever first occurs.
b. Carter must file a financing statement, or a copy of a security agreement, signed by the debtor to perfect its security interest.
c. Carter has a perfected security interest in the collateral.
d. Carter must sign the agreement, and a financing statement, and file either one of them to perfect its security interest in the shares of stock.

43. On February 1, 1975, Colonial Industries ordered 10,000 feet of two-inch pipe in 20-foot lengths from the Eire Steel Company. Delivery was to be made on or before March 15, time being of the essence, FOB buyer's loading platform, cash on delivery. Eire Steel accepted the order. On February 15, Eire informed Colonial that its biggest customer had just purchased and taken delivery of its entire stock of two-inch pipe and that it would be impossible for Eire to deliver the pipe until May 15, at the earliest. Colonial demanded that Eire perform as agreed; Eire apologized but reiterated its prior position that it was now impossible for them to perform until the middle of May.

a. Eire's action of February 15 constituted an anticipatory repudiation of the contract.
b. Colonial must "cover" (procure the same or similar goods elsewhere) within a reasonable time in order to determine the damages recoverable.
c. If Colonial waits for performance by Eire and tenders the amount due on March 15, it can recover damages of the difference between the contract price and the market value on March 15.
d. Because Eire had sold and delivered all its supply of two-inch pipe, it can successfully plead impossibility of performance in order to avoid liability.

44. Busby & Nelson, a general partnership, is a small furniture manufacturing company located in a southwestern state. It sells most of its products to fine furniture stores in Chicago, Los Angeles, and New York. It employs 50 skilled workmen and 10 other employees. Busby & Nelson has elected **not** to be covered under the state law which provides for elective workmen's compensation coverage because its safety standards are excellent, and there has **not** been a serious employee injury for several years. Busby & Nelson

a. Would **not** be held liable for workmen's compensation to an injured employee if the injury was due to the employee's negligence.
b. Is obligated to pay workmen's compensation benefits to its employees even though such coverage was optional.
c. Is subject to lawsuits for damages by injured employees and may **not** assert the common-law defenses such as contributory negligence.
d. **Cannot** create any type of pension plan for the partners and its employees which will permit payments thereto to be deducted in whole or part for federal-income-tax purposes.

45. Case Corporation manufactures electric drills and sells them to retail hardware stores. Under the Uniform Commercial Code, it is likely that

a. The drills are inventory in Case's hands.
b. The drills are equipment in Case's hands.
c. The raw materials on hand to be used in the manufacturing of the drills are **not** inventory in Case's hands.
d. The drills are considered equipment in the hands of the hardware stores who purchased them.

46. Draper Corporation, a retail merchant, was indebted to Cramer Corporation in the amount of $25,000 arising out of the sale of goods delivered to Draper on credit. Cramer and Draper signed a security agreement creating a security interest in certain collateral of Draper. The collateral was described in the security agreement as "the inventory of Draper Corporation, presently existing and thereafter acquired." This description of Draper's collateral
   a. Is insufficient because it is too broad.
   b. Is sufficient.
   c. Must be more specific for the security interest to be perfected.
   d. Is sufficient, but the security interest is valid only insofar as it is limited to Draper's presently existing inventory.

47. On May 1, Dixie Corporation borrowed $100,000 from Clark Bank. The bank filed a financing statement on that date. On May 5, Dixie signed a security agreement granting the bank a security interest in its inventory, its accounts receivable, and the proceeds from the sale of its inventory and collection of its accounts receivable. The bank's security interest
   a. Was perfected on May 1.
   b. Was **not** perfected until a copy of the security agreement was filed.
   c. Was perfected on May 5.
   d. Attached on May 1.

48. Hadley, Baxendale, & Champagne, CPAs, is a large national accounting firm. Its clients are some of the largest corporations in the United States. As such
   a. The firm could **not** incorporate for federal-income-tax purposes.
   b. The partners, **not** being employees, are **not** covered by the federal Social Security Act.
   c. The firm is subject to the federal antitrust laws.
   d. The firm is exempt from state workmen's compensation laws.

Number 4 (Estimated time — 25 to 30 minutes)

Part a. Byron Corporation acquired more than 70 percent of the outstanding common stock of Sage, Inc., during the last twelve months; most of the shares were purchased from five of Sage's directors who owned approximately 60 percent of Sage's outstanding common stock which they sold to Byron. These five individuals were on the board of directors of both Sage and Byron for many years and still remain on both boards. Also, Byron utilized its ownership control to elect the remaining members of the board of directors and its own slate of officers of Sage.

Sage and Byron are manufacturers of goods which are in competition throughout the United States. Since the time that Byron acquired control of Sage, Sage's competitive position has weakened in a number of markets in various sections of the country.

Required:

Discuss the legal implications of federal antitrust and general corporate law concerning the above facts.

Part b. You have just begun your first examination of the financial statements of Burke Corporation. Your examination is for the year ended December 31, 1974. Burke has never been audited before and is not subject to the Securities Act of 1933 or the Securities Exchange Act of 1934.

You have extracted the following information from Burke's general ledger and the corporation's Articles of Incorporation.

Stockholders' Equity

8%, cumulative, nonvoting preferred stock; par value, $100 per share; authorized, issued, and outstanding, 10,000 shares; liquidation preference, $115 per share aggregating $1,150,000	$1,000,000
Common stock; par value, $10 per share; authorized, 100,000 shares; issued and outstanding 10,000 shares	100,000
Additional paid-in capital	50,000
Retained earnings	110,000
Total	$1,260,000

Your preliminary inquiry has revealed the following information:

- Burke was incorporated in 1965 in a state which had adopted the Model Business Corporation Act.
- No dividends have been declared or paid on the preferred stock for 1973 and 1974. Dividends on the preferred stock had been declared and paid in all prior years. The preferred stock was issued six years ago at par to a group of local investors different from the common stockholders.
- Dividends of $20,000 were declared and paid on the common stock in both 1973 and 1974. Annual dividends have been declared and paid on the 10,000 shares of common stock outstanding since Burke's incorporation. The common stock is closely held and most of the common stockholders are members of the board of directors, officers, or employees.
- Burke's net income was $50,000 and $40,000 for 1973 and 1974, respectively. The $110,000 balance of retained earnings at December 31, 1974, was after closing the books on that date.
- Burke is and has been solvent since its incorporation.

Required:

Discuss the legal implications of the above facts to Burke, its directors, and its stockholders.

Number 5 (Estimated time –– 25 to 30 minutes)

Part a. Millard & Hans, CPAs, has been engaged for several years by Happy Toys, Inc., to perform the "usual" examination of its financial statements and provide other accounting services. The understanding was oral, and the fee was based on an annual retainer.

Millard & Hans regularly prepared unaudited quarterly financial statements and examined and reported on Happy Toys' annual financial statements. During the current year's examination, Happy Toys decided to go public and requested that Millard & Hans assists in preparing all the necessary financial statements and other financial information and supply the independent auditor's reports as necessary for inclusion in a registration statement to be filed with the Securities and Exchange Commission (SEC). Millard & Hans is independent in accordance with SEC rules and regulations. Millard & Hans complied with Happy Toys' request and subsequently submitted a bill to Happy Toys for $15,000 for the additional work performed in connection with the SEC filing. Happy Toys refused to pay, claiming the additional work was a part of the "usual" engagement and was covered by the annual retainer.

Required:

1. If Millard & Hans sues Happy Toys for its $15,000 fee, who is likely to prevail? Explain.
2. Discuss how Millard & Hans can avoid similar problems in the future with Happy Toys and other clients.

Part b. Whitlow and Wyatt, CPAs, has been the independent auditors of Interstate Land Development Corporation for several years. During these years, Interstate prepared and filed its own annual income tax returns.

During 1974, Interstate requested Whitlow and Wyatt to examine all the necessary financial statements of the corporation to be submitted to the Securities and Exchange Commission (SEC) in connection with a multi-state public offering of one-million shares of Interstate common stock. This public offering came under the provisions of the Securities Act of 1933. The examination was performed carefully and the financial statements were fairly presented for the respective periods. These financial statements were included in the registration statement filed with the SEC.

While the registration statement was being processed by the SEC but prior to the effective date, the Internal Revenue Service (IRS) subpoenaed Whitlow and Wyatt to turn over all its working papers relating to Interstate for the years 1971-1973. Whitlow and Wyatt initially refused to comply for two reasons. First, Whitlow and Wyatt did not prepare Interstate's tax returns. Second, Whitlow and Wyatt claimed that the working papers were confidential matters subject to the privileged-communications rule. Subsequently, however, Whitlow and Wyatt did relinquish the subpoenaed working papers.

Upon receiving the subpoena, Wyatt called Dunkirk, the chairman of Interstate's board of directors and asked him about the IRS investigation. Dunkirk responded, "I'm sure the IRS people are on a fishing expedition and that they will not find any material deficiencies."

A few days later Dunkirk received written confirmation from the IRS that it was contending that Interstate had underpaid its taxes during the period under review. The confirmation revealed that Interstate was being assessed $800,000 including penalties and interest for the three years.

This $800,000 assessment was material relative to the financial statements as of December 31, 1974. The amount for each year individually exclusive of penalty and interest was not material relative to each respective year.

Required:

1. Discuss the additional liability assumed by Whitlow and Wyatt in connection with this SEC registration engagement.
2. Discuss the implications to Whitlow and Wyatt and its responsibilities with respect to the IRS assessment.
3. Could Whitlow and Wyatt have validly refused to surrender the subpoenaed materials? Explain.

Number 6 (Estimated time — 25 to 30 minutes)

During its annual examination of the financial statements of Ramrod Corporation, Farr & Williamson, CPAs, discovered the following problem involving an account receivable from DeMars Corporation. As of December 31, 1974, DeMars was three months in arrears on purchases of $21,690 made in late September 1974. In addition, a letter dated November 30, 1974, indicated that DeMars would not be able to pay its outstanding obligations because an involuntary petition in bankruptcy had been filed on November 21, 1974. The trustee in bankruptcy has indicated that, based upon a conservative estimate, DeMars will pay 10 cents on the dollar.

Further investigation revealed that DeMars was one of Ramrod's oldest and most-cherished customers. Not only that, but Fairmont, Ramrod's president, was a close personal friend and golfing partner of Goodson, DeMars' president. As a result of this relationship, Goodson had telephoned Fairmont on November 12, 1974, and informed him that DeMars' other creditors were in the process of preparing and filing an involuntary bankruptcy petition against it and that its financial condition had badly deteriorated. It was agreed by the two parties that Ramrod should take a secured position on the $21,690 arrearage via the assignment of $21,690 of DeMars' accounts receivable. This was done and a financing statement was duly signed by the parties and filed on November 15, 1974.

Later in its examination of Ramrod's financial statements, Farr & Williamson learned of another problem related to DeMars. Because of the close relationship between the companies and their presidents, Fairmont had urged Ramrod's board of directors in early January 1974 to authorize him to sign the corporate name as surety for a $200,000 loan which DeMars was negotiating with Local Lending Corporation. The loan was to be secured by a first mortgage on DeMars' real property. The fair market value of the real property at that time was $200,000; however, because it was Local Lending's policy not to loan in excess of 75% of the security's fair market value, it was insisting upon a satisfactory surety on the loan. Additionally, Local Lending was worried about DeMars' financial condition. On January 10, 1974, Fairmont was authorized to sign the corporate name as an accommodation indorser on the $200,000 loan which was consummated that day. The current fair market value of the real property is approximately $180,000. DeMars is in default and Local Lending has demanded that Ramrod satisfy the debt.

Required:

a. Will Ramrod be able to successfully assert the standing of a secured creditor in the bankruptcy proceeding in respect to the $21,690 account receivable? Explain.

b. Discuss the legal rights of the parties and how Ramrod should account for the $21,690 receivable from DeMars and the related assignment of $21,690 of DeMars' receivables if

1. Ramrod qualifies as a secured creditor in the bankruptcy proceeding.
2. Ramrod does not qualify as a secured creditor in the bankruptcy proceeding.

c. Is Ramrod liable on its accommodation indorsement on the $200,000 loan from Local Lending to DeMars? Explain.

d. Assuming Ramrod is liable on its accommodation indorsement, can Ramrod force Local Lending to first resort to its mortgage before proceeding against Ramrod? Explain.

e. Assuming Ramrod is liable on its accommodation indorsement and has paid Local Lending the balance due ($190,260) on the loan by Local Lending to DeMars, what rights and standing does Ramrod have in bankruptcy as a result? Explain.

Number 7 (Estimated time — 25 to 30 minutes)

The facts in **Part b.** are related to the facts in **Part a.** but each part can be considered and answered independently. **Part c.** is totally independent of **Parts a.** and **b.**

Part a. For several years Dillon & Dodd, CPAs, has been retained to examine the financial statements of Marc Corporation. Shortly before beginning the examination for the year ended December 31, 1974, Mr. Dodd received a telephone call from Marc's president indicating that he believed something unusual was going on and that it probably involved some sort of embezzlement. The president further indicated that his suspicions were first aroused about three months earlier when he noted that the cash position was significantly lower than in prior years. The president then requested that Dillon & Dodd immediately undertake a special investigation to determine the amount of embezzlement if any.

After a month of investigation, Dillon & Dodd uncovered an embezzlement scheme involving the collusion of the head timekeeper and the treasurer's secretary. The scheme worked as follows:

- The treasurer's secretary processed all paperwork in conjunction with cash disbursements, including payroll, and typed all checks for the treasurer's signature.
- The treasurer relied on his secretary and routinely signed checks without reviewing the underlying documentation. The treasurer returned the signed checks to his secretary for mailing or distribution.

- The timekeeper supplied the treasurer's secretary with punched time cards for fictitious employees and invoices, receiving reports, and purchase orders for fictitious suppliers.
- The treasurer's secretary would prepare checks for the fictitious employees and suppliers, and after the checks were signed she would extract the "bogus" checks. Then, either she or the timekeeper would indorse the checks and cash them or deposit them in various banks where they maintained accounts in the names of the fictitious payees.

The investigation revealed that the embezzlement scheme had been operating for ten months and that over $18,000 had been embezzled by the time the scheme was exposed. Most of the money had already been dissipated.

On the basis of the facts revealed by the investigation, Marc seeks to hold either the banks that cashed the checks or its own bank responsible for the loss.

Required:

Will Marc prevail? Explain.

Part b. Payday at Marc Corporation occurred five days before the embezzlement scheme was exposed by Dillon & Dodd. Having become suspicious of the questions the auditors were asking and the additional information they were seeking and obtaining, the timekeeper and the secretary decided to work their embezzlement one more time and then flee the state. They submitted twelve bogus checks totaling $1,380 and absconded with them on payday. They immediately deposited the checks in the various bank accounts which they had set up to facilitate their fraudulent scheme. Most of the banks permitted the embezzlers to withdraw the entire balance of the account prior to clearance of the final deposit. Others insisted upon waiting until the checks cleared.

When Marc's treasurer was informed of the embezzlement scheme, he immediately called the corporation's bank and told the bank manager to stop payment on the bogus checks. This was confirmed in writing two days later. It was subsequently learned that Marc's bank (the drawee bank) had processed the twelve bogus checks as follows:

- Prior to receiving the oral stop-payment order, six checks totaling $850 were processed and paid.
- At the time of receiving the oral stop-payment order, three checks totaling $250 were being processed and were, in fact, paid after Marc's bank received the oral stop-payment order.
- The other three checks totaling $280 were processed one week after receipt of Marc's stop-payment order. Of these checks one for $100 was paid by Marc's bank. The remaining two checks, one for $110 and one for $70, were caught by the bank's employees, payment was stopped, and the checks were returned to the appropriate banks. Only the bank where the $110 check was returned had not let the embezzlers withdraw the funds; thus, the $110 amount was charged against the embezzlers' account balance.

Required:

What, if anything, can Marc recover from the banks in question? Discuss all items.

Part c. John Ford signed a check for $1,000 on January 25, 1975, payable to the order of Charles Benson Manufacturing, a sole proprietorship. The check was dated February 1, 1975. Benson indorsed the check to Francis Factoring, Inc., by writing on the back of the check: "Pay only to Francis Factoring, Inc., Charles Benson." After Benson delivered the check to Francis Factoring, Francis Factoring immediately took the check to First National Bank, the drawee, and had the check certified. Francis Factoring then indorsed the check in blank to Hills Brokerage Corporation in payment of materials purchased.

Required:

1. Did the indorsement, "Pay only to Francis Factoring, Inc.," stop the negotiability of the check and legally require the drawee bank to pay the proceeds of the check to Francis Factoring only? Explain.
2. Can Hills Brokerage qualify as a valid holder of the check with all the rights of a holder in due course? Explain.
3. Assuming Hills Brokerage qualifies as a holder in due course, can it successfully sue First National Bank if the bank refuses to honor the check on February 1? Explain.
4. Assuming Hills Brokerage qualifies as a holder in due course, can it successfully sue Ford for the proceeds of the check if the bank refuses to honor it on February 1? Explain.
5. Assuming Hills Brokerage qualifies as a holder in due course, can it successfully sue Benson for the proceeds of the check if the bank refuses to honor it on February 1? Explain.
6. Assuming Hills Brokerage qualifies as a holder in due course, can it successfully sue Francis Factoring for the proceeds of the check if the bank refuses to honor it on February 1? Explain.

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING THEORY

(Theory of Accounts)

May 9, 1975; 1:30 to 5:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	25	30
No. 2	25	30
No. 3	25	30
No. 4	25	30
No. 5	25	30
No. 6	25	30
No. 7	25	30
Total for examination	175	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of issues in financial accounting.** Use a soft pencil, preferably No 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The recommended title for the financial statement which summarizes changes in financial position is the statement of
   a. Changes in financial position.
   b. Changes in working capital.
   c. Sources and applications of funds.
   d. Cash flow.

Answer Sheet

99. a. ▬▬▬ b. :::::::::: c. :::::::::: d. ::::::::::

Items to be Answered

1. When a corporation redeems all of its preferred stock for more than the original issue price, the excess paid above the original issue price should be
   a. Accounted for as an extraordinary loss in the income statement.
   b. Charged against paid-in capital of common stock.
   c. Charged to a discount on preferred stock account.
   d. Charged against retained earnings.

2. What is the preferred method of handling unamortized discount, issue cost, and redemption premium on bonds refunded?
   a. Expense them in the period the bonds are refunded.
   b. Amortize them over the life of the new issue.
   c. Amortize them over the remaining life of the issue retired.
   d. Amortize them over the remaining life of the issue retired or the life of the new issue, whichever is shorter.

3. Costs incurred in connection with the issuance of ten-year bonds which sold at a slight premium should be
   a. Charged to retained earnings when the bonds are issued.
   b. Expensed in the year in which incurred.
   c. Capitalized as organization costs.
   d. Reported on the balance sheet as an asset and amortized over the ten-year bond term.

4. Partners C and K share profits and losses equally after each has been credited in all circumstances with annual salary allowances of $15,000 and $12,000, respectively. Under this arrangement, C will benefit by $3,000 more than K in which of the following circumstances?
   a. Only if the partnership has earnings of $27,000 or more for the year.
   b. Only if the partnership does **not** incur a loss for the year.
   c. In all earnings or loss situations.
   d. Only if the partnership has earnings of at least $3,000 for the year.

5. Pat, Helma, and Diane are partners with capital balances of $50,000, $30,000, and $20,000, respectively. The partners share profits and losses equally. For an investment of $50,000 cash, MaryAnn is to be admitted as a partner with a one-fourth interest in capital and profits. Based on this information, the amount of MaryAnn's investment can **best** be justified by which of the following?
   a. MaryAnn will receive a bonus from the other partners upon her admission to the partnership.
   b. Assets of the partnership were overvalued immediately prior to MaryAnn's investment.
   c. The book value of the partnership's net assets was less than their fair value immediately prior to MaryAnn's investment.
   d. MaryAnn is apparently bringing goodwill into the partnership and her capital account will be credited for the appropriate amount.

6. Q, R, S, and T are partners sharing profits and losses equally. The partnership is insolvent and is to be liquidated; the status of the partnership and each partner is as follows:

	Partnership Capital Balance	*Personal Assets (Exclusive of Partnership Interest)*	*Personal Liabilities (Exclusive of Partnership Interest)*
Q	$15,000	$100,000	$40,000
R	10,000	30,000	60,000
S	(20,000)	80,000	5,000
T	(30,000)	1,000	28,000
Total	$(25,000)		

Assuming the Uniform Partnership Act applies, the partnership creditors
   a. Must first seek recovery against S because he is solvent personally and he has a negative capital balance.
   b. Will **not** be paid in full regardless of how they proceed legally because the partnership assets are less than the partnership liabilities.
   c. Will have to share R's interest in the partnership on a pro rata basis with R's personal creditors.
   d. Have first claim to the partnership assets before any partner's personal creditors have rights to the partnership assets.

7. Where the statement of financial position indicates that a portion of property, plant, and equipment and of the related accumulated depreciation pertains to equipment leased to customers, it is evident that the
   a. Operating method of accounting is used for these leases.
   b. Financing method of accounting is used for these leases.
   c. Lessor has violated generally accepted accounting principles.
   d. Lessor is using the income-tax method of accounting for these leases.

8. Under the provisions of Accounting Principles Board Opinions, when leases are treated as installment purchases the method of amortization should be appropriate to the nature and use of the asset and should be chosen
   a. To result in a level annual pattern of charges to expense over the useful life of the property.
   b. To result in a level annual rate of return on the capitalized amount over the useful life of the property.
   c. To result in an annual pattern of charges to expense based on the annual change in the present value of the related obligation.
   d. Without reference to the period over which the related obligation is discharged.

9. Interperiod income tax allocation in corporate financial statements can **best** be justified by which of the following accounting concepts or principles?
   a. Conservatism.
   b. Matching.
   c. Realization.
   d. Objectivity.

10. Which of the following is the primary element that distinguishes accounting for corporations from accounting for other legal forms of business organization (such as partnerships)?
   a. The entity theory relates primarily to the other forms of business organization.
   b. The corporation draws a sharper distinction in accounting for sources of capital.
   c. In a corporation retained earnings may be reduced only by the declaration of dividends.
   d. Generally accepted accounting principles apply to corporations but have relatively little applicability to other forms of business organization.

11. Which of the following statements is the assumption on which straight-line depreciation is based?
   a. The operating efficiency of the asset decreases in later years.
   b. Service value declines as a function of time rather than use.
   c. Service value declines as a function of obsolescence rather than time.
   d. Physical wear and tear are more important than economic obsolescence.

12. Iden Company leased a warehouse from Jarrold, Inc., on January 2, 1974, for five years at a fixed rental payment each year. On April 1, 1974, Iden subleased the same warehouse to Walter Company for a substantially larger yearly rental for the 4 years and 9 months remaining on the lease. Walter is a well established company with an excellent credit rating and earnings history. Both the lease and sublease are noncancelable. How should Iden disclose the lease and sublease on its financial statements at December 31, 1974?
   a. By means of a footnote to the financial statements only.
   b. **No** disclosure is needed in the balance sheet or in the footnotes because Iden's earnings statement should show rental revenue received from Walter and rental expense paid to Jarrold.
   c. Iden should capitalize the lease payments to be made to Jarrold and amortize the balance over the five years of the lease. **No** disclosure needs to be made for the sublease.
   d. Iden's statement of financial position should include an asset and a deferred credit each for the present value of the difference between the amount to be received from the sublease and the amount to be paid for the lease.

13. When an accounts-receivable aging schedule is prepared at the end of the fiscal year, a series of computations like the following is sometimes made: 5% of the total dollar balance of accounts from 1-30 days past due, plus 10% of the total dollar balance of accounts from 31-60 days past due, *et seq.* Which of the following statements **best** describes how the sum of the amounts determined in this series of computations is used?
   a. When added to the total of accounts written off during the year, this new sum is the desired credit balance of the allowance for doubtful accounts to be reported in the year-end financial statements.
   b. It is the amount of bad debts expense for the year.
   c. It is the amount that should be added to the allowance for doubtful accounts at year end.
   d. It is the amount of the desired credit balance of the allowance for doubtful accounts to be reported in the year-end financial statements.

14. Accounting requires the preparation of statements that summarize exchange transactions in terms of some unit of measurement. Revenue is expressed as the number of dollars received or the dollar equivalent of the commodities or services received; cost is expressed as the number of dollars paid out or the dollar equivalent of the items given up. Fluctuations in the value of the dollar are ignored. The above describes what accounting assumption or principle?
   a. Going-concern.
   b. Unit-of-measure.
   c. Historical-cost.
   d. Realization.

15. When costs can be reasonably associated with specific revenues but **not** with specific products the costs should be
    a. Charged to expense in the period incurred.
    b. Allocated to specific products based on the best estimate of the production processing time.
    c. Expensed in the period in which the related revenue is recognized.
    d. Capitalized and then amortized over a period **not** to exceed 60 months.

16. Estimated liabilities are disclosed in financial statements by
    a. A footnote to the statements.
    b. Showing the amount among the liabilities but **not** extending it to the liability total.
    c. An appropriation of retained earnings.
    d. Appropriately classifying them as regular liabilities in the balance sheet.

17. Tramway Corporation is a stable, going concern which each year invests about $25,000 in new plant and equipment as an equal amount of older equipment is retired. It has been reporting income for both tax and financial-statement purposes by using straight-line depreciation, but it has now changed to accelerated depreciation for tax purposes. This difference in depreciation methods will cause a deferred tax credit which over the years will build up
    a. And then remain relatively constant.
    b. Rapidly and then slowly increase.
    c. Indefinitely.
    d. Rapidly and then slowly decline.

18. A material loss arising from the devaluation of the currency of a country in which a corporation was conducting foreign operations through a branch would be reflected in the company's year-end financial statements as
    a. An asset to be subsequently offset against gains from foreign currency revaluations.
    b. A factor in determining earnings before extraordinary items in the year during which the loss occurred.
    c. An extraordinary item on the earnings statement of the year during which the loss occurred.
    d. A prior period adjustment unless the operations of the foreign branch had begun during the year in which the loss occurred.

19. Which of the following statements **best** describes the net effect on retained earnings of the purchase and subsequent sale of treasury stock?
    a. Retained earnings may never be increased, but sometimes is decreased.
    b. Retained earnings may never be increased or decreased.
    c. Retained earnings sometimes is increased, but may never be decreased.
    d. Retained earnings is always affected unless the selling price is exactly equal to cost.

20. What is the most appropriate basis for recording the acquisition of 40% of the stock in another company if the acquisition was a noncash transaction?
    a. At the book value of the consideration given.
    b. At the par value of the stock acquired.
    c. At the book value of the stock acquired.
    d. At the fair value of the consideration given.

Number 2 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of issues in managerial accounting.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

21. What term identifies an accounting system in which the operations of the business are broken down into cost centers and the control function of a foreman, sales manager, or supervisor is emphasized?
    a. Responsibility accounting.
    b. Operations-research accounting.
    c. Control accounting.
    d. Budgetary accounting.

22. Which of the following capital-expenditure planning and control techniques has been criticized because it fails to consider investment profitability?
    a. Payback method.
    b. Average-return-on-investment method.
    c. Present-value method.
    d. Time-adjusted-rate-of-return method.

23. Which of the following capital-expenditure planning and control techniques has been criticized because it might mistakenly imply that earnings are reinvested at the rate of return earned by the investment?
    a. Payback method.
    b. Average-return-on-investment method.
    c. Present-value method.
    d. Time-adjusted-rate-of-return method.

24. When a manufacturing company has a highly automated manufacturing plant producing many different products, what is probably the **most** appropriate basis of applying factory-overhead costs to work in process?
    a. Direct-labor hours.
    b. Direct-labor dollars.
    c. Machine hours.
    d. Cost of materials used.

25. In a process costing system how is the unit cost affected in a production-cost report when materials are added in a department subsequent to the first department and the added materials result in additional units?
   a. It causes an increase in the preceding department's unit cost which necessitates an adjustment of the transferred-in unit cost.
   b. It causes a decrease in the preceding department's unit cost which necessitates an adjustment of the transferred-in unit cost.
   c. It causes an increase in the preceding department's unit cost but does **not** necessitate an adjustment of the transferred-in unit cost.
   d. It causes a decrease in the preceding department's unit cost but does **not** necessitate an adjustment of the transferred-in unit cost.

26. Given the following notations, what is the break-even sales level in units?
SP = selling price per unit
FC = total fixed cost
VC = variable cost per unit
   a. $\frac{SP}{FC \div VC}$
   b. $\frac{FC}{VC \div SP}$
   c. $\frac{VC}{SP - FC}$
   d. $\frac{FC}{SP - VC}$

27. When should process-costing techniques be used in assigning costs to products?
   a. If the product is manufactured on the basis of each order received.
   b. When production is only partially completed during the accounting period.
   c. If the product is composed of mass-produced homogeneous units.
   d. In situations where standard costing techniques should **not** be used.

28. A company increased the selling price for its product from $1.00 to $1.10 a unit when total fixed costs increased from $400,000 to $480,000 and variable cost per unit remained unchanged. How would these changes affect the break-even point?
   a. The break-even point in units would be increased.
   b. The break-even point in units would be decreased.
   c. The break-even point in units would remain unchanged.
   d. The effect **cannot** be determined from the information given.

29. The term "relevant range" as used in cost accounting means the range over which
   a. Costs may fluctuate.
   b. Cost relationships are valid.
   c. Production may vary.
   d. Relevant costs are incurred.

30. Which of the following **best** identifies the reason for using probabilities in capital-budgeting decisions?
   a. Uncertainty.
   b. Cost of capital.
   c. Time-value of money.
   d. Projects with unequal lives.

31. The contribution margin per unit is the difference between the selling price and the variable cost per unit, and the contribution margin ratio is the ratio of the contribution margin to the selling price per unit. If the selling price and the variable cost per unit both increase 10% and fixed costs do **not** change, what is the effect on the contribution margin per unit and the contribution margin ratio?
   a. Contribution margin per unit and the contribution margin ratio both remain unchanged.
   b. Contribution margin per unit and the contribution margin ratio both increase.
   c. Contribution margin per unit increases and the contribution margin ratio remains unchanged.
   d. Contribution margin per unit increases and the contribution margin ratio decreases.

32. Quepea Company manufactures two products, Q and P, in a small building with limited capacity. The selling price, cost data, and production time are given below:

	Product Q	*Product P*
Selling price per unit	$20	$17
Variable costs of producing and selling a unit	$12	$13
Hours to produce a unit	3	1

Based on this information, the profit maximization objective function for a linear-programming solution may be stated as
   a. Maximize $20Q + $17P.
   b. Maximize $12Q + $13P.
   c. Maximize $3Q + $1P.
   d. Maximize $8Q + $4P.

33. The management of a chain of stores has data on individual store profitability and variables relevant to profitability, such as store-area population and average income level. Predictions of the probable profitability of potential store sites may be facilitated by the use of
   a. Regression analysis.
   b. Linear programming.
   c. Learning-curve analysis.
   d. Queuing-theory analysis.

34. A firm is scheduling a long-term research and development project for a recently received government contract. If a stringent time schedule must be met by a limited research staff and the interrelated activities are extensive and complex, what is the most appropriate approach for planning and controlling the project?
   a. Cost-volume-earnings analysis.
   b. Parametric programming.
   c. Program evaluation review technique (PERT).
   d. Queuing-theory analysis.

35. A firm has data relating total production costs to volume for each quarter during the past five years. During this period production volume has varied substantially, the method of production has been relatively unchanged, and the cost behavior has been complex. What is the most appropriate method for estimating future production costs?
   a. Cost-volume-earnings analysis.
   b. Cross-sectional analysis.
   c. Program evaluation review technique (PERT).
   d. Time-series or trend-regression analysis.

36. Which of the following statements **best** describes a by-product?
   a. A product that is produced from material that would otherwise be scrap.
   b. A product that has a lower unit selling price than the main product.
   c. A product created along with the main product whose sales value does **not** cover its cost of production.
   d. A product that usually produces a small amount of revenue when compared to the main product revenue.

37. Application rates for factory overhead **best** reflect anticipated fluctuations in sales over a cycle of years when they are computed under the concept of
   a. Maximum capacity.
   b. Normal capacity.
   c. Practical capacity.
   d. Expected-actual capacity.

38. What standard cost variance represents the difference between actual factory overhead incurred and budgeted factory overhead based on actual hours worked?
   a. Volume variance.
   b. Spending variance.
   c. Efficiency variance.
   d. Quantity variance.

39. What does a credit balance in a direct-labor efficiency variance account indicate?
   a. The average wage rate paid to direct-labor employees was less than the standard rate.
   b. The standard hours allowed for the units produced were greater than actual direct-labor hours used.
   c. Actual total direct-labor costs incurred were less than standard direct-labor costs allowed for the units produced.
   d. The number of units produced was less than the number of units budgeted for the period.

40. Which of the following is a **more** descriptive term of the type of cost accounting often called "direct costing"?
   a. Out-of-pocket costing.
   b. Variable costing.
   c. Relevant costing.
   d. Prime costing.

Number 3 (Estimated time –– 25 to 30 minutes)

The Anderson Manufacturing Company, a California corporation listed on the Pacific Coast Stock Exchange, budgeted activities for 1975 as follows:

	Amount	*Units*
Net sales	$6,000,000	1,000,000
Cost of goods sold	3,600,000	1,000,000
Gross margin	$2,400,000	
Selling, general, and administrative expenses	1,400,000	
Operating earnings	$1,000,000	
Nonoperating revenues and expenses	–0–	
Earnings before income taxes	$1,000,000	
Estimated income taxes (current and deferred)	550,000	
Net earnings	$ 450,000	
Earnings per share of common stock	$4.50	

Anderson has operated profitably for many years and has experienced a seasonal pattern of sales volume and production similar to the following ones forecasted for 1975.

Sales volume is expected to follow a quarterly pattern of 10%, 20%, 35%, 35%, respectively, because of the seasonality of the industry. Also, due to production and storage capacity limitations it is expected that production will follow a pattern of 20%, 25%, 30%, 25%, per quarter, respectively.

At the conclusion of the the first quarter of 1975, the controller of Anderson has prepared and issued the following interim report for public release:

	Amount	*Units*
Net sales	$ 600,000	100,000
Cost of goods sold	360,000	100,000
Gross margin	$ 240,000	
Selling, general, and administrative expenses	275,000	
Operating loss	$ (35,000)	
Loss from warehouse fire	(175,000)	
Loss before income taxes	$(210,000)	
Estimated income taxes	–0–	
Net loss	$(210,000)	
Loss per share of common stock	$(2.10)	

The following additional information is available for the first quarter just completed, but was not included in the public information released:

1. The company uses a standard cost system in which standards are set at currently attainable levels on an annual basis. At the end of the first quarter there was underapplied fixed factory overhead (volume variance) of $50,000 that was treated as an asset at the end of the quarter. Production during the quarter was 200,000 units, of which 100,000 were sold.

2. The selling, general, and administrative expenses were budgeted on a basis of $900,000 fixed expenses for the year plus $0.50 variable expenses per unit of sales.

3. Assume that the warehouse fire loss met the conditions of an extraordinary loss. The warehouse had an undepreciated cost of $320,000; $145,000 was recovered from insurance on the warehouse. No other gains or losses are anticipated this year from similiar events or transactions, nor has Anderson had any similar losses in preceding years; thus, the full loss will be deductible as an ordinary loss for income tax purposes.

4. The effective income tax rate, for federal and state taxes combined, is expected to average 55% of earnings before income taxes during 1975. There are no permanent differences between pretax accounting earnings and taxable income.

5. Earnings per share were computed on the basis of 100,000 shares of capital stock outstanding. Anderson has only one class of stock issued, no long-term debt outstanding, and no stock option plan.

Required:

a. Without reference to the specific situation described above, what are the standards of disclosure for interim financial data (published interim financial reports) for publicly traded companies? Explain.

b. Identify the weaknesses in form and content of Anderson's interim report without reference to the additional information.

c. For each of the five items of additional information, indicate the preferable treatment for each item for interim-reporting purposes and explain why that treatment is preferable.

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

On January 2, 1975, Asch Corporation paid $1,000,000 cash for all of Bacher Company's outstanding stock. The recorded amount (book value) of Bacher's net assets on January 2 was $880,000. Both Asch and Bacher have operated profitably for many years, both have December 31 accounting year ends, and each has only one class of stock outstanding. This business combination should be accounted for by the purchase method in which Asch should follow certain principles in allocating its investment cost to the assets acquired and liabilities assumed.

Required:

a. Describe the principles that Asch should follow in allocating its investment cost to the assets purchased and liabilities assumed for a January 2, 1975, consolidated balance sheet. Explain.

b. Independent of your answer to part **a.**, assume that on January 2, 1975, Asch acquired all of Bacher's outstanding stock in a stock-for-stock exchange and that all other conditions prerequisite to a pooling of interests were met. Describe the principles that Asch should follow in applying the pooling of interests method to this business combination when combining the balance-sheet accounts of both companies in the preparation of a consolidated balance sheet on January 2, 1975.

Number 5 (Estimated time — 25 to 30 minutes)

Leininger Wholesale Company has been growing rapidly, but during this period of rapid growth the accounting records have not been properly maintained. You were recently employed to correct the accounting records and to assist in the preparation of the financial statements for the fiscal year ended February 28, 1975. One of the accounts you have been analyzing is entitled "Merchandise." That account in summary form follows. Numbers in parentheses following each entry correspond to related numbered explanations and additional information which you have accumulated during your analysis.

Merchandise

Balance, March 1, 1974	(1)	Merchandise sold	(5)
Purchases	(2)	Consigned merchandise	(6)
Freight-in	(3)		
Insurance	(4)		
Freight-out on consigned merchandise	(7)		
Freight-out on merchandise sold	(8)		

Explanations and Additional Information

(1) You have satisfied yourself that the March 1, 1974, inventory balance represents the approximate cost of the few units in inventory at the beginning of the year. Leininger employs the FIFO method of accounting for inventories.

(2) The merchandise purchased was recorded in the account at the vendors' catalog list price which is the price appearing on the face of each vendor's invoice. All purchased merchandise is subject to a trade (chain) discount of 20% - 10%. These discounts have been accounted for as revenue when the merchandise was paid for.

All merchandise purchased was also subject to cash terms of 2/15, n/30. During the fiscal year Leininger recorded $3,500 in cash discounts as revenue when the merchandise was paid for. Some cash discounts were lost because payment was made after the discount period ended. All purchases of merchandise were paid for in the fiscal year they were recorded as purchased.

(3) All merchandise is purchased FOB vendors' business locations. The freight-in amount is the cost of transporting the merchandise from the vendors' business locations to Leininger.

(4) The insurance charge is for an all-perils policy to cover merchandise in transit to Leininger from vendors.

(5) The credit to this account for merchandise sold represents the vendors' catalog list price of merchandise sold plus the cost of the beginning inventory; the debit side of the entry was made to the cost of goods sold account.

(6) Consigned merchandise represents goods that were shipped to Lee Company during January 1975, priced at the vendors' catalog list price. The offsetting debit was made to accounts receivable when the merchandise was shipped to Lee. Leininger does not account for consigned goods and consignment profits separately; therefore, it commingles all consignment inventories, costs, expenses, and revenues with those from nonconsigned goods.

On March 5, 1975, Leininger received a payment from Lee for one-third of the consigned merchandise, the quantity that was sold through February 28, 1975; the payment was recorded as a reduction in accounts receivable. Lee sold the merchandise at the agreed price, deducted its 16% sales commission and 4% advertising allowance, and remitted the difference. The remaining two-thirds of the consigned merchandise was unsold and held by Lee on February 28, 1975.

(7) The freight-out on consigned goods is the cost of trucking the consigned goods to Lee from Leininger.

(8) Freight-out on merchandise sold is the amount paid trucking companies to deliver merchandise sold to Leininger's customers.

Required:

Consider each of the eight (8) numbered items independently and explain specifically how and why each item should have (if correctly accounted for) affected

- The amount of cost of goods sold to be included in Leininger's earnings statement, and
- The amount of any other account to be included in Leininger's February 28, 1975, financial statements.

Organize your answer in the following format:

Item Number	*How and Why the Amount of Cost of Goods Sold Should Have been Affected*	*How and Why the Amount of Any Other Account Should Have been Affected*

Number 6 (Estimated time -- 25 to 30 minutes)

William Bates is executive vice-president of Mavis Industries, Inc., a publicly held industrial corporation. Bates has just been elected to the city council of Gotham City. Prior to assuming office as a city councilman, he asks you as his CPA to explain the major differences that exist in accounting and financial reporting for a large city when compared to a large industrial corporation.

Required:

a. Describe the major differences that exist in the purpose of accounting and financial reporting and in the types of financial reports of a large city when compared to a large industrial corporation.

b. Why are inventories often ignored in accounting for local governmental units? Explain.

c. Under what circumstances should depreciation be recognized in accounting for local governmental units? Explain.

Number 7 (Estimated time -- 25 to 30 minutes)

Published financial statements of United States companies are currently prepared on a stable-dollar assumption even though the general purchasing power of the dollar has declined considerably because of inflation in recent years. To account for this changing value of the dollar, many accountants suggest that financial statements should be adjusted for general price-level changes. Three independent, unrelated statements regarding general price-level adjusted financial statements follow. Each statement contains some fallacious reasoning.

Statement I

The accounting profession has not seriously considered price-level adjusted financial statements before because the rate of inflation usually has been so small from year-to-year that the adjustments would have been immaterial in amount. Price-level adjusted financial statements represent a departure from the historical-cost basis of accounting. Financial statements should be prepared from facts, not estimates.

Statement II

If financial statements were adjusted for general price-level changes, depreciation charges in the earnings statement would permit the recovery of dollars of current purchasing power and, thereby, equal the cost of new assets to replace the old ones. General price-level adjusted data would yield statement-of-financial-position amounts closely approximating current values. Furthermore, management can make better decisions if general price-level adjusted financial statements are published.

Statement III

When adjusting financial data for general price-level changes, a distinction must be made between monetary and nonmonetary assets and liabilities, which, under the historical-cost basis of accounting, have been identified as "current" and "noncurrent." When using the historical-cost basis of accounting, no purchasing-power gain or loss is recognized in the accounting process, but when financial statements are adjusted for general price-level changes, a purchasing-power gain or loss will be recognized on monetary and nonmonetary items.

Required:

Evaluate each of the independent statements and identify the areas of fallacious reasoning in each and explain why the reasoning is incorrect. Complete your discussion of each statement before proceeding to the next statement.

Uniform Certified Public Accountant Examination

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING PRACTICE — PART I

November 5, 1975; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	Estimated Minutes *Minimum*	*Maximum*
No. 1	40	50
No. 2	50	60
No. 3	50	60
No. 4	40	50
No. 5	40	50
Total	220	270

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, number the pages in sequence for that question with the lead schedule first, followed by supporting computations. For instance, if you use three pages for Question No. 3, you should show Question 3, Page 1 of 3, Page 2 of 3, and Page 3 of 3. The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. **Enclose all scratch sheets.** Failure to enclose scratch sheets may result in loss of grading points. Scratch sheets need not have page numbers, but you should show the question number and place them immediately following the question to which they relate.

3. Fourteen-column sheets should not be folded until all sheets, both wide and narrow, are placed in the proper sequence and fastened together at the top left corner. All fourteen-column sheets should then be wrapped around the back of the papers.

4. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 40 to 50 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of financial-accounting problems.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to $5,260,000; sales returns and allowances reduced the amounts owed by $160,000. How much were net sales last year for Baker Company?
   a. $4,800,000.
   b. $5,100,000.
   c. $5,200,000.
   d. $5,260,000.

Answer Sheet

97. a. :::::::::: b. ▬▬▬ c. :::::::::: d. ::::::::::

Items to be Answered

1. Bigo Corporation owns 1,000 shares of common stock of Berg, Inc., a large publicly traded company listed on a major stock exchange. If Berg issues a 20% stock dividend when the par value is $10 per share and the market value is $70 per share, how much and what type of income should Bigo report?
   a. Zero.
   b. $2,000 ordinary income.
   c. $14,000 ordinary income.
   d. $2,000 ordinary income and $12,000 extraordinary income.

2. Adams, Inc., owns 50 shares of the outstanding common stock of Bland Corporation, which has several hundred thousand shares publicly traded. These 50 shares were purchased by Adams in 1973 for $100 per share. On August 30, 1975, Bland distributed 50 stock rights to Adams. Adams was entitled to buy one new share of Bland common stock for $90 cash and two of these rights. On August 30, 1975, each share of stock had a market value of $132 ex-rights, and each right had a market value of $18. What cost should be recorded for each new share that Adams acquires by exercising the rights?
   a. $90.
   b. $114.
   c. $126.
   d. $132.

Items 3 and 4 are based on the following information:

On June 30, 1975, Axel, Inc., acquired Belle, Inc., in a business combination properly accounted for as a pooling of interests. Axel exchanged six of its shares of common stock for each share of Belle's outstanding common stock. June 30 was the fiscal year end for both companies. There were **no** intercompany transactions during the year. The balance sheets immediately before the combination follow:

	Axel	*Belle*	
	Book Value	*Book Value*	*Fair Value*
Current assets	$ 40,000	$ 30,000	$ 45,000
Equipment (net)	150,000	120,000	140,000
Land	30,000	–	–
	$220,000	$150,000	$185,000
Current liabilities	$ 35,000	$ 15,000	$ 15,000
Notes payable	40,000	–	–
Bonds payable	–	100,000	100,000
Common stock ($1 par)	75,000	–	–
Common stock ($5 par)	–	50,000	–
Retained earnings	70,000	(15,000)	–
	$220,000	$150,000	

3. What was the retained earnings balance on the combined balance sheet at June 30, 1975?
   a. $45,000.
   b. $55,000.
   c. $70,000.
   d. $80,000.

4. How should the combined net income for the year be computed?
   a. Use only Axel's income because the combination occurred on the last day of the fiscal year.
   b. Use only Belle's income because the combination occurred on the last day of the fiscal year.
   c. Add together both companies' incomes even though the combination occurred on the last day of the fiscal year.
   d. Add together both companies' incomes and subtract the annual amortization of goodwill.

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5. Andrew Corporation declared a stock dividend of 5,000 shares when the par value was $1 per share, and the market value was $4 per share. How does the entry to record this declaration affect total stockholders' equity?
   a. No effect.
   b. $5,000 increase.
   c. $5,000 decrease.
   d. $20,000 decrease.

6. In a business combination accounted for as a purchase, how should the excess of fair value of net assets acquired over cost be treated?
   a. Amortized as a credit to income over a period **not** to exceed forty years.
   b. Amortized as a charge to expense over a period **not** to exceed forty years.
   c. Amortized directly to retained earnings over a period **not** to exceed forty years.
   d. Allocated as a reduction of noncurrent assets other than long-term investments in marketable securities.

7. Which of the following situations would affect the account "deferred income taxes"?
   a. An excess of percentage depletion over cost depletion.
   b. Interest received on municipal bonds.
   c. Differences in depreciation because property is carried at one basis for accounting purposes and at a different basis for tax purposes.
   d. Pension costs recorded for accounting purposes as per APB Opinion No. 8 and deducted for tax purposes when paid.

8. Baker,Inc., owns 35% of the outstanding stock of Cable, Inc. During the calendar year 1974, Baker's "Investment in Cable" account appeared as follows:

Balance, January 1, 1974	$650,000
Equity in 1974 earnings of Cable	100,000
Dividends received from Cable – 1974	(20,000)
Balance, December 31, 1974	$730,000

Baker feels that its equity in Cable's undistributed earnings will be realized in the form of future dividends. Assuming a 40% income tax rate, by how much should deferred income taxes be affected because of these facts?
   a. $4,800.
   b. $6,000.
   c. $7,200.
   d. $9,000.

9. On June 2, 1975, Crane Corporation issued one hundred $1,000 bonds (total face value of $100,000) due in ten years. Interest at 6% is payable annually on June 1. One detachable stock purchase warrant was attached to each bond. The bonds were sold at 105. The fair value of the bonds without the stock warrants is 96-3/5. The fair value of each detachable warrant is $84. How much should Crane have charged to bond discount?
   a. **Nothing** because there is a bond premium of $5,000.
   b. $3,400.
   c. $5,000.
   d. $8,400.

Items 10 and 11 are based on the following information:

Comparative balance sheets are presented for Shelby, Inc., a calendar-year company.

	December 31, 1974 Dr. (Cr.)	December 31, 1973 Dr. (Cr.)
Current assets	$237,000	$160,000
Equipment	615,000	600,000
Accumulated depreciation	(218,000)	(210,000)
Goodwill	240,000	250,000
	$874,000	$800,000
Current liabilities	$(180,000)	$ (80,000)
Bonds payable	(200,000)	(300,000)
Discount on bonds	–	4,000
Common stock	(550,000)	(550,000)
Retained earnings	56,000	126,000
	$(874,000)	$(800,000)

You have discovered the following facts:

- During 1974, Shelby sold at **no** gain or loss equipment with a book value of $38,000 and purchased new equipment costing $75,000.
- During 1974, bonds with a face value of $100,000 were extinguished. They were **not** current liabilities prior to their extinguishment.
- Retained earnings was affected only by the 1974 net income or loss.

10. How much working capital was provided by operations during 1974 (net income adjusted for items **not** affecting working capital)?
   a. $104,000.
   b. $106,000.
   c. $110,000.
   d. $114,000.

11. Assume that $100,000 face value of bonds became current at December 31, 1974, to be repaid in early 1975. What should be the change in working capital under this assumption after considering **all** changes in financial position?
   a. $23,000 increase.
   b. $23,000 decrease.
   c. $123,000 increase.
   d. $123,000 decrease.

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12. A company sold bonds on July 1, 1975, with a face value of $100,000 and due in ten years. The stated annual interest rate is 6%, payable semi-annually on June 30 and December 31. These bonds were sold to yield 8%. The present value of $1 for twenty periods at 4% is $0.4563. The present value of an annuity of $1 in arrears for twenty periods at 4% is $13.5903. For how much did these bonds sell on July 1, 1975 (rounded to nearest dollar)?
   a. $86,401.
   b. $91,542.
   c. $100,000.
   d. $127,172.

13. Foster Company wants to finance some long-term assets by selling bonds. Management projects the earnings **before** deducting bond interest expense and income taxes as $1,166,000 per year. Foster's income tax rate is 40%. Management wants its net earnings **after** deducting bond interest expense and income taxes to be ten times the bond interest expense. Assuming the bonds can be sold at face value, what amount should Foster issue at 8%?
   a. Approximately $560,580.
   b. Exactly $583,000.
   c. Exactly $825,000.
   d. Exactly $874,500.

14. Which one of the following transactions would affect a statement of changes in financial position in which funds are defined as cash, but **not** one in which funds are defined as working capital?
   a. Recording a net loss from operations.
   b. Amortizing a premium on bonds.
   c. Acquiring treasury stock.
   d. Paying last year's federal income tax liability.

Items 15, 16, and 17 are based on the following information:

On January 2, 1974, Lessor Corporation leased some equipment to Lessee Corporation. Both corporations are on a calendar year. This equipment had cost Lessor $45,000. There were **no** other significant costs associated with the lease. Lessor appropriately accounted for this transaction as a lease equivalent to a sale, and Lessee appropriately treated it as a capitalized lease under an installment purchase. The lease is for a noncancelable term of eight years with $10,000 rent payable at the beginning of each year. Lessee made the first payment on January 2, 1974. The implicit interest rate is 10% and the present value of an annuity of $1 in advance for eight years at 10% is $5.868. The "interest" method of amortization is used. The equipment is expected to have a ten-year life, **no** salvage value, and be depreciated on a straight-line basis.

15. What journal entry should Lessor have made on January 2, 1974, to reflect the transaction as a lease equivalent to a sale?

		Debit	*Credit*
a.	Cash	$10,000	
	Investment in leased equipment	45,000	
	Unearned rental revenue		$10,000
	Equipment inventory		45,000
b.	Receivable	35,000	
	Cash	10,000	
	Equipment inventory		45,000
c.	Receivable	48,680	
	Cash	10,000	
	Cost of sales	45,000	
	Sales		58,680
	Equipment inventory		45,000
d.	Receivable	70,000	
	Cash	10,000	
	Cost of sales	45,000	
	Sales		80,000
	Equipment inventory		45,000

16. What journal entry should Lessor have made on January 2, 1974, if this lease were to have been accounted for as an operating lease?

		Debit	*Credit*
a.	Cash	$10,000	
	Investment in leased equipment	45,000	
	Unearned rental revenue		$10,000
	Equipment inventory		45,000
b.	Receivable	35,000	
	Cash	10,000	
	Equipment inventory		45,000
c.	Receivable	48,680	
	Cash	10,000	
	Cost of sales	45,000	
	Sales		58,680
	Equipment inventory		45,000
d.	Receivable	70,000	
	Cash	10,000	
	Cost of sales	45,000	
	Sales		80,000
	Equipment inventory		45,000

17. Assume that Lessee treated this transaction as an operating (true) lease rather than as a purchase of the equipment. By how much would 1974 income before income taxes differ between these two methods?
    a. Zero.
    b. $736.
    c. $4,132.
    d. $5,132.

Number 2 (Estimated time — 50 to 60 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of managerial-accounting and quantitative-methods problems.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

18. A company had income of $50,000 using direct costing for a given period. Beginning and ending inventories for that period were 13,000 units and 18,000 units, respectively. **Ignoring income taxes,** if the fixed overhead application rate was $2.00 per unit, what was the income using absorption costing?
    a. $40,000.
    b. $50,000.
    c. $60,000.
    d. Cannot be determined from the information given.

19. The following data apply to Frelm Corporation for a given period:

Total variable cost per unit	$3.50
Contribution margin ÷ sales	30%
Breakeven sales (present volume)	$1,000,000

Frelm wants to sell an additional 50,000 units at the same selling price and contribution margin. By how much can fixed costs increase to generate a gross margin equal to 10% of the sales value of the additional 50,000 units to be sold?
    a. $50,000.
    b. $57,500.
    c. $67,500.
    d. $125,000.

20. Total production costs for Gallop, Inc., are budgeted at $230,000 for 50,000 units of budgeted output and at $280,000 for 60,000 units of budgeted output. Because of the need for additional facilities, budgeted fixed costs for 60,000 units are 25% more than budgeted fixed costs for 50,000 units. How much is Gallop's budgeted variable cost per unit of output?
    a. $1.60.
    b. $1.67.
    c. $3.00.
    d. $5.00.

21. Which one of the following notations represents the first half-year's depreciation on a new asset using the sum-of-the-years'-digits depreciation method, a fifty-year life, and a cost (net of salvage) of $40,000?
    a. $\$40{,}000 \times (25 \div \sum_{Y=1}^{25} Y)$.
    b. $\$40{,}000 \times (25 \div \sum_{Y=1}^{50} Y)$.
    c. $\$40{,}000 \times (50 \div \sum_{Y=1}^{25} Y)$.
    d. $\$40{,}000 \times (50 \div \sum_{Y=1}^{50} Y)$.

22. Your client, a charity, is planning a carnival to raise money. The charity has permission from the local authorities to have games of chance. For one of these games, the player draws one card from a standard deck of 52 cards. If the player draws a jack of hearts, jack of diamonds, or jack of spades, he is paid $6.50. If he draws any card of clubs, he is paid $2.50. Assume X equals the price your client should charge per draw so that the long-run expected value of this game is zero. Which one of the following equations should be used to determine that price?
    a. $\frac{3}{52}(6.50-X) + \frac{13}{52}(2.50-X) = X.$
    b. $\frac{3}{52}(6.50-X) + \frac{13}{52}(2.50-X) = \frac{36}{52}X.$
    c. $\frac{3}{52}(6.50) + \frac{13}{52}(2.50) = \frac{36}{52}X.$
    d. $6.50 - 2.50 = \frac{36}{52}X.$

23. Patsy, Inc., manufactures two products, X and Y. Each product must be processed in each of three departments: machining, assembling, and finishing. The hours needed to produce one unit of product per department and the maximum possible hours per department follow:

	Production Hours Per Unit		*Maximum Capacity In Hours*
Department	*X*	*Y*	
Machining	2	1	420
Assembling	2	2	500
Finishing	2	3	600

Other restrictions follow:

$X \geqslant 50$
$Y \geqslant 50$

The objective function is to maximize profits where profit = \$4X + \$2Y. Given the objective and constraints, what is the most profitable number of units of X and Y, respectively, to manufacture?

a. 150 and 100.
b. 165 and 90.
c. 170 and 80.
d. 200 and 50.

Items 24 and 25 are based on the following information:

Your client, Globe Manufacturing, has several plants in different cities and serves customers in various other cities. Globe wants to know the best way to schedule shipments from various plants to various customers. You advise Globe that the problem can be solved by using the transportation method of linear programming.

24. In a transportation minimization problem, what are the usual coefficients of the objective function?

a. Usage rates for transportation facilities.
b. Restrictions on transportation facilities.
c. Shipping costs.
d. Time estimates for the critical path.

25. If the number of units at supply points exceeds the number of units demanded at destinations, what action should be taken concerning this inequality of supply and demand?

a. Include a "dummy" demand equal to the excess supply.
b. Consider the excess supply to be a "dummy" supply.
c. Eliminate the excess supply.
d. Proceed **without** modification.

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26. A company places orders for inventory with its suppliers for a certain item for which the order size is determined in advance as

$$\text{Order Size} = \sqrt{\frac{2 \times \text{Cost to Place One Order} \times \text{Demand per Period}}{\text{Cost to Hold One Unit for One Period}}}$$

All orders are the same size. When the policy is implemented, demand per period is only one-half what was expected when order size was computed. Consequently, actual total inventory cost will be

a. Larger than if the expected demand per period had occurred and larger than if the actual demand per period had been used to calculate order size.
b. Larger than if the expected demand per period had occurred and smaller than if the actual demand per period had been used to calculate order size.
c. Smaller than if the expected demand per period had occurred and larger than if the actual demand per period had been used to calculate order size.
d. Smaller than if the expected demand per period had occurred and smaller than if the actual demand per period had been used to calculate order size.

27. Mar Company has two decentralized divisions, X and Y. Division X has always purchased certain units from Division Y at \$75 per unit. Because Division Y plans to raise the price to \$100 per unit, Division X desires to purchase these units from outside suppliers for \$75 per unit. Division Y's costs follow:

Y's variable costs per unit	\$70
Y's annual fixed costs	\$15,000
Y's annual production of these units for X	1,000 units

If Division X buys from an outside supplier, the facilities Division Y uses to manufacture these units would remain idle. What would be the result if Mar enforces a transfer price of \$100 per unit between Divisions X and Y?

a. It would be suboptimization for the company because X should buy from outside suppliers at \$75 per unit.
b. It would provide lower overall company net income than a transfer price of \$75 per unit.
c. It would provide higher overall company net income than a transfer price of \$75 per unit.
d. It would be more profitable for the company than allowing X to buy from outside suppliers at \$75 per unit.

28. A business determines its inventory policy using the economic-order-quantity model that allows a finite stockout cost per period and backordering. Which one of the following statements accurately describes that stockout cost?
    a. The stockout cost will have to be accumulated in a special account for comparison with expected stockout cost.
    b. The smaller the stockout cost, the more often stockout will occur.
    c. The larger the stockout cost, the more often stockout will occur.
    d. The smaller the stockout cost, the larger will be the average amount of inventory on hand.

29. The following data refer to various annual costs relating to the inventory of a single-product company:

	Cost Per Unit
Transportation-in on purchases	$.20
Storage	.12
Insurance	.10

	Total Per Year
Interest that could have been earned on alternate investment of funds	$800
Units required	10,000

What is the annual carrying cost per unit?
    a. $.22.
    b. $.30.
    c. $.42.
    d. $.50.

30. A company bought Machine 1 on March 5, 1974, for $5,000 cash. The estimated salvage was $200 and the estimated life was eleven years. On March 5, 1975, the company learned that it could purchase a different machine for $8,000 cash. The new machine would save the company an estimated $250 per year compared to Machine 1. The new machine would have **no** estimated salvage and an estimated life of ten years. The company could get $3,000 for Machine 1 on March 5, 1975. **Ignoring income taxes,** which of the following calculations would best assist the company in deciding whether to purchase the new machine?
    a. (Present value of an annuity of $250) + $3,000 – $8,000.
    b. (Present value of an annuity of $250) – $8,000.
    c. (Present value of an annuity of $250) + $3,000 – $8,000 – $5,000.
    d. (Present value of an annuity of $250) + $3,000 – $8,000 – $4,800.

31. Which one of the following statements **best** describes cost allocation?
    a. A company can maximize or minimize total company income by selecting different bases to allocate indirect costs.
    b. A company should select an allocation base to raise or lower reported income on given products.
    c. A company's total income will remain unchanged no matter how indirect costs are allocated.
    d. A company, as a general rule, should allocate indirect costs randomly or based on an "ability-to-bear" criterion.

32. A small-scale representation of a business to predict the effect of alternate strategies is called a
    a. Critical path.
    b. Decentralized unit.
    c. Model.
    d. System.

33. The mathematical notation for the total cost for a business is $2X^3 + 4X^2 + 3X + 5$ where X equals production volume. Which of the following is the mathematical notation for the marginal cost function for this business?
    a. $2(X^3 + 2X^2 + 1.5X + 2.5)$.
    b. $6X^2 + 8X + 3$.
    c. $2X^3 + 4X^2 + 3X$.
    d. $3X + 5$.

34. Your client, a bank, is interested in knowing how many tellers to keep on duty during various times of the day. What quantitative technique should this bank use?
    a. PERT.
    b. Simplex algorithm.
    c. Dynamic programming.
    d. Queuing theory.

35. Your client, a retail store, is interested in the relationship between sales (independent variable) and theft losses (dependent variable). Using the proper formula, you compute the coefficient of correlation as .95. What can you definitely conclude about these factors (sales and theft losses)?
    a. An increase in sales causes an increase in theft losses.
    b. Movement of these factors is in opposite directions.
    c. Movement of these factors is entirely unrelated.
    d. Movement of these factors is in the same direction.

Number 3 (Estimated time -- 50 to 60 minutes)

You have been engaged by the Plentiful Heat Company to adjust its financial statements for the years ended June 30, 1975, and June 30, 1974. The Company manufactures, sells, and services forced-air heating systems for the home. The Company's financial statements for the year ended June 30, 1973, were audited by another CPA who gave an unqualified opinion thereon.

The Company's financial statements as prepared by its controller for the years ended June 30, 1975, and June 30, 1974, are presented below:

Plentiful Heat Company
BALANCE SHEET

Assets	*June 30, 1975*	*1974*
Current assets:		
Cash	$ 120,000	$ 103,000
Accounts receivable (less allowance for doubtful accounts of $95,000 at June 30, 1975, and June 30, 1974)	824,000	602,000
Inventory, heating systems	1,801,000	1,604,000
Inventory, spare parts	198,000	137,000
Prepaid expenses	144,000	144,000
Total current assets	3,087,000	2,590,000
Property and equipment:		
Land	113,000	–
Machinery and equipment (less accumulated depreciation of $923,000 at June 30, 1975, and $751,000 at June 30, 1974)	1,561,150	1,522,000
Leasehold improvements (less accumulated amortization of $1,050)	82,950	–
Total property and equipment	1,757,100	1,522,000
Total assets	$4,844,100	$4,112,000

Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 449,000	$ 462,000
Accrued liabilities	82,000	46,000
Total current liabilities	531,000	508,000
Stockholders' equity:		
Common stock, authorized 100,000 shares, par value $10 per share, issued and outstanding 53,300 shares at June 30, 1975, and 53,000 shares at June 30, 1974	533,000	530,000
Retained earnings	3,780,100	3,074,000
Total stockholders' equity	4,313,100	3,604,000
Total liabilities and stockholders' equity	$4,844,100	$4,112,000

Plentiful Heat Company
STATEMENT OF INCOME

	Year ended June 30, 1975	*1974*
Sales of heating systems	$4,907,000	$4,265,000
Revenues from service and repairs	73,000	49,000
Total revenues	4,980,000	4,314,000
Cost of sales	3,121,000	2,650,000
Cost of service and repairs	41,000	27,000
Total	3,162,000	2,677,000
Gross margin	1,818,000	1,637,000
Selling, general, and administrative expenses	1,111,900	1,004,000
Income before income taxes	$ 706,100	$ 633,000

The following additional information regarding the Company is available:

- Your review of accounts receivable disclosed that the following items are included in the "accounts receivable" account balance at June 30, 1975:

Receivables from officers (1975)	$11,800
Customer trade accounts receivable known to be uncollectible on sales recorded in fiscal year 1974	80,000

- Historical data indicate that 2% of heating system sales for the year ended June 30, 1975, will prove uncollectible. **No** accounts receivable have been written off during the year ended June 30, 1975.
- On June 30, 1974, spare parts costing $17,280 were on hand, but had **not** been included in the physical inventory on that date although the liability for them had been recorded. In addition, the inventory on June 30, 1975, included spare parts sold during April 1975, for $5,000 and returned on June 17, 1975. **No** entry had been made to adjust the customer's account for the return, and the merchandise was included in the inventory at selling price which was 125% of cost.
- Annual service contracts are sold to homeowners for $70, covering labor charges on all service or repair calls during the year as well as an annual inspection and cleaning of the heating system. All contracts commence on January 1 of each year. With few exceptions, almost all repair calls occur between September 1 and June 30 and during this period, the number of calls remains stable from month to month. During the months of July and August, the Company performs its annual inspection and cleaning service for contractholders. The charge for a similar inspection and cleaning service to customers who do not have contracts is $10. The Company had 400 contracts in the calendar year 1974 and 600 contracts in the calendar year 1975. The Company had $10,200 of unearned service contract revenue on its June 30, 1973, balance sheet.

- On June 2, 1975, the Company paid $110,000 cash and issued 300 shares of its common stock having a fair market value of $27 per share at the date of transfer for a parcel of property consisting of land and an unused building. The property was acquired in order to secure a building site for a new warehouse. At the date of transfer the Company assumed and paid property taxes in arrears of $2,000. By June 18, the building was demolished at a cost of $20,000. Scrap materials recovered from the demolition yielded $16,000.

The payment of the property taxes and the net cost of demolishing the building were charged to selling, general, and administrative expenses. The issuance of the 300 shares of stock had **no** material effect on the market for the Company's common stock.

- On April 1, 1974, the Company leased a building to be used as its corporate headquarters. The lease, which was appropriately **not** capitalized, was for fifteen years at an annual rental of $96,000, payable in advance on each April 1. On that date, the Company paid the landlord the sum of $144,000 and charged this amount to prepaid expenses. This payment covered the first year's rent and a refundable security deposit to be held in escrow by the landlord. On April 1, 1975, the annual rental of $96,000 was paid.

- On April 1, 1975, the Company had an inter-office communications system installed in its offices at a cost of $84,000. This system has an estimated useful life of twenty years, but the system will have to be abandoned by the Company if its lease is not renewed.

- The Company has an incentive commission plan for its salesmen entitling them to an additional commission when actual quarterly sales exceed budgeted estimates. An analysis of the account "incentive commission expense" at June 30, 1975, follows:

Amount	*For Quarter Ending*	*Date Paid*
$18,000	June 30, 1974	July 10, 1974
21,000	September 30, 1974	October 11, 1974
26,000	December 31, 1974	January 9, 1975
17,000	June 30, 1975	July 11, 1975
$82,000		

Note: **No** payment was made for the first quarter of the calendar year 1975, as quarterly sales did **not** meet the requirements of the plan.

Required:

Prepare a worksheet showing the adjustments required to correct the financial statements of the Plentiful Heat Company for the years ended June 30, 1975, and June 30, 1974. Though these entries may be used later to prepare entries to adjust the books, their purpose on this worksheet is to adjust the amounts shown in the financial statements. Show supporting computations in good form. **Ignore income taxes and deferred tax considerations in your answer.** The columns on this worksheet should have the following headings:

	June 30, 1975			*June 30, 1974*		
Explanation	*Income Statement Dr. (Cr.)*	*Balance Sheet Dr. (Cr.)*	*Account*	*Income Statement Dr. (Cr.)*	*Balance Sheet Dr. (Cr.)*	*Account*

Number 4 (Estimated time –– 40 to 50 minutes)

Your tax clients, Mr. and Mrs. Dupres, want you to calculate their 1974 federal taxable income. You have gathered from them the following data relating to the calendar year 1974:

- Mr. and Mrs. Dupres, both 50, file a joint tax return. Mr. Dupres provided over half the support of his son, Thomas, who is a full-time student and who earned $2,000 at various part-time jobs in 1974. Mr. Dupres also provided over half the support of his father-in-law, Mr. Carmas, a widower, who is 75 and lives alone in a nearby town. Mr. Carmas received social security payments of $3,660 in 1974 and had **no** other income.
- Mr. Dupres owns a 50% interest in the partnership of Dupres and Garner. This calendar-year partnership showed the following amounts on its 1974 federal income tax return for the **entire** business:

Ordinary income	$54,000
Net short-term capital gain	8,400
Net long-term capital loss	(22,200)
Charitable contributions	(160)
Partners' drawings	(61,000)

- Mr. Dupres also owns a 30% interest in the Marker Corporation, a calendar-year Subchapter S corporation. There was **no** undistributed taxable income at December 31, 1973. At December 31, 1974, Marker had $10,000 of undistributed taxable income. During 1974, Marker paid dividends of $13,000. Mrs. Dupres works part time for this corporation and earned $5,200 for 1974.
- The Dupres family lived on two floors of a three-story house which Mr. Dupres owned until he sold it in late December 1974. While he owned this house, he rented the third floor to another person, and treated one-third of the expenses as applying to the rented portion.

The following data relate to 1974 during which the property was rented:

Rental income	$2,900
Utilities and maintenance (on rented part only)	510
Property taxes (on entire house)	3,300
Interest on mortgage (on entire house)	2,700

- The house was sold in late December 1974 for $111,000, net of commissions. There were **no** fixing-up expenses. Mr. Dupres had purchased the house in January 1965 for $102,000 of which $12,000 was allocable to land. He immediately rented one-third of the premises. Mr. Dupres had used straight-line depreciation with no estimated salvage value and a forty-year life. After selling the house, the Dupres family purchased another house for $69,200.
- In January 1974, Mr. Dupres received various shares of corporate stock as a gift from a rich uncle. This stock had cost his uncle $4,500 several years earlier and had a fair market value of $4,300 at the date of the gift. Mr. Dupres sold all this stock in December 1974 for $4,360.
- In addition to the above data, Mr. and Mrs. Dupres incurred other losses for 1974 as follows:

Sale of other rental property on January 2, 1974	$16,000
Sale of nonbusiness automobile (new automobile purchased for $5,850)	1,620
Nonbusiness bad debt	700

- Mr. and Mrs. Dupres had other income for 1974 as follows:

Interest from savings account	$1,300
Dividends, Mutual Fund (capital gain distribution)	1,200

- During 1974, nonbusiness property worth $340 was stolen from Mr. Dupres. There was **no** insurance recovery.
- Mr. and Mrs. Dupres contributed to various charities as follows:

Fair value of services for volunteer charity work	$850
Cash pledge to church – 1974 ($180 paid in 1974)	650
Cash pledge to church – 1973 ($140 paid in 1974)	190
Fair value of stock when given to Red Cross ($125 cost – held for three months)	135
Cash expenses incurred for volunteer charity work	60
Cash paid to various indigent individuals	25

• Mr. and Mrs. Dupres had other expenditures for 1974 as follows:

Federal income taxes paid-in and withheld	$8,000
State income taxes paid-in and withheld	2,080
State sales tax	220
State gasoline tax	70
Federal excise tax	50
Fee for income tax return preparation	300
Drugs and other medical **after** considering the 1% and 3% adjustments	402

Required:

Prepare a worksheet to be used for the preparation of the 1974 federal income tax return for Mr. and Mrs. Dupres. The columns on this worksheet should have the following headings:

Description
Taxable Ordinary Income (Loss)
Short-term Capital Gains and (Losses)
Long-term Capital Gains and (Losses)
Personal Deductions and Exemptions
Exempt Income and Nondeductible Items

Provide supporting schedules for income and expenses from rental property and gain or loss from sale of house, both the rental and nonbusiness portions. Show other supporting computations in separate schedules as necessary. Any possible alternative treatments should be resolved in a manner that will minimize taxable income for 1974.

Number 5 (Estimated time — 40 to 50 minutes)

Milner Manufacturing Company uses a job-order costing system and standard costs. It manufactures one product whose standard cost is as follows:

Materials	20 yards at $.90 per yard	$18
Direct labor	4 hours at $6.00 per hour	24
Total factory overhead	Applied at five-sixths of direct labor (the ratio of variable costs to fixed costs is 3 to 1)	20
Variable selling, general, and administrative expenses		12
Fixed selling, general, and administrative expenses		7
Total unit cost		$81

The standards are set based on "normal" activity of 2,400 direct-labor hours.

Actual activity for the month of October 1975 was as follows:

Materials purchased	18,000 yards at $.92 per yard	$16,560
Materials used	9,500 yards	
Direct labor	2,100 hours at $6.10 per hour	12,810
Total factory overhead	500 units actually produced	11,100

Required:

a. Based on the standard costs, compute the inventoriable unit cost for internal reporting purposes under direct (variable) costing.

b. Based on the standard costs, a certain selling price per unit and number of units will yield an operating profit of $5,200. Increasing this selling price by 4% will increase the operating profit to $6,800. All costs and the number of units remain unchanged. Compute the selling price per unit and the number of units to yield an operating profit of $5,200.

c. Compute the variable factory-overhead rate per direct-labor hour and the total fixed factory overhead based on "normal" activity.

d. Prepare a schedule computing the following variances for the month of October 1975:

1) Materials price variance.
2) Materials usage variance.
3) Labor rate variance.
4) Labor usage (efficiency) variance.
5) Controllable (budget or spending) overhead variance.
6) Volume (capacity) overhead variance.

Indicate whether each variance is favorable or unfavorable.

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING PRACTICE -- PART II

November 6, 1975; 1:30 to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	40	50
No. 2	50	60
No. 3	40	50
No. 4	40	50
No. 5	50	60
Total	220	270

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, number the pages in sequence for that question with the lead schedule first, followed by supporting computations. For instance, if you use three pages for Question No. 3, you should show Question 3, Page 1 of 3, Page 2 of 3, and Page 3 of 3. The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. **Enclose all scratch sheets.** Failure to enclose scratch sheets may result in loss of grading points. Scratch sheets need not have page numbers, but you should show the question number and place them immediately following the question to which they relate.

3. Fourteen-column sheets should not be folded until all sheets, both wide and narrow, are placed in the proper sequence and fastened together at the top left corner. All fourteen-column sheets should then be wrapped around the back of the papers.

4. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 40 to 50 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of financial-accounting problems.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to $5,260,000; sales returns and allowances reduced the amounts owed by $160,000. How much were net sales last year for Baker Company?
   a. $4,800,000.
   b. $5,100,000.
   c. $5,200,000.
   d. $5,260,000.

Answer Sheet

97. a. :::::::::: b. ▬▬▬ c. :::::::::: d. ::::::::::

Items to be Answered

1. The balance sheet for the partnership of Lang, Monte, and Newton at April 30, 1975, follows. The partners share profits and losses in the ratio of 2:2:6, respectively.

Assets, at cost	$100,000
Lang, loan	$ 9,000
Lang, capital	15,000
Monte, capital	31,000
Newton, capital	45,000
Total	$100,000

Lang is retiring from the partnership. By mutual agreement, the assets are to be adjusted to their fair value of $130,000 at April 30, 1975. Monte and Newton agree that the partnership will pay Lang $37,000 cash for his partnership interest, exclusive of his loan which is to be paid in full. **No** goodwill is to be recorded. What is the balance of Newton's capital account after Lang's retirement?
   a. $51,000.
   b. $53,400.
   c. $59,000.
   d. $63,000.

2. William desires to purchase a one-fourth capital and profit and loss interest in the partnership of Eli, George, and Dick. The three partners agree to sell William one-fourth of their respective capital and profit and loss interests in exchange for a total payment of $40,000. The capital accounts and the respective percentage interests in profits and losses immediately before the sale to William follow:

	Capital Accounts	*Percentage Interests in Profits and Losses*
Eli	$ 80,000	60%
George	40,000	30
Dick	20,000	10
Total	$140,000	100%

All other assets and liabilities are fairly valued and implied goodwill is to be recorded prior to the acquisition by William. Immediately after William's acquisition, what should be the capital balances of Eli, George, and Dick, respectively?
   a. $60,000; $30,000; $15,000.
   b. $69,000; $34,500; $16,500.
   c. $77,000; $38,500; $19,500.
   d. $92,000; $46,000; $22,000.

Items 3 and 4 are based on the following information:

The following balance sheet is for the AdGenDa partnership. The partners, Ad, Gen, and Da, share profits and losses in the ratio of 5:3:2, respectively.

Cash	$ 30,000
Other assets	270,000
	$300,000
Liabilities	$ 70,000
Ad, Capital	140,000
Gen, Capital	80,000
Da, Capital	10,000
	$300,000

3. The assets and liabilities are fairly valued on the above balance sheet and the partnership wishes to admit Melvin as a new partner with a one-fifth interest **without** recording goodwill or bonus. How much should Melvin contribute in cash or other assets?
   a. $36,800.
   b. $46,000.
   c. $57,500.
   d. $60,000.

4. Assume that the original partners have agreed to liquidate the partnership by selling the other assets. What should each of the respective partners receive if the other assets are sold for $200,000?
   a. Ad, $102,500; Gen, $57,500; Da, $0.
   b. Ad, $103,000; Gen, $57,000; Da, $0.
   c. Ad, $105,000; Gen, $59,000; Da, $4,000.
   d. Ad, $140,000; Gen, $80,000; Da, $10,000.

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5. The Maddox Corporation acquired land, buildings, and equipment from a bankrupt company at a lump-sum price of $90,000. At the time of acquisition, Maddox paid $6,000 to have the assets appraised. The appraisal disclosed the following values:

Land	$60,000
Buildings	40,000
Equipment	20,000

What cost should be assigned to the land, buildings, and equipment, respectively?
   a. $30,000, $30,000, and $30,000.
   b. $32,000, $32,000, and $32,000.
   c. $45,000, $30,000, and $15,000.
   d. $48,000, $32,000, and $16,000.

6. The Mon Corporation acquired a 30% interest in the Soon Company on January 1, 1974, for $600,000. At that time, Soon had 2,000,000 shares of its $1 par value common stock issued and outstanding. During 1974, Soon paid cash dividends of $20,000 and thereafter declared and issued a 5% common stock dividend when the market value was $2 per share. Soon's net income for 1974 was $120,000. What should be the balance in Mon's "Investment in Soon Company" account at the end of 1974?
   a. $570,000.
   b. $600,000.
   c. $630,000.
   d. $636,000.

7. Eltro Company acquired a 70% interest in the Samson Company in 1972. For the years ended December 31, 1973 and 1974, Samson reported net income of $80,000 and $90,000, respectively. During 1973, Samson sold merchandise to Eltro for $10,000 at a profit of $2,000. The merchandise was later resold by Eltro to outsiders for $15,000 during 1974. For consolidation purposes what is the minority interest's share of Samson's net income for 1973 and 1974, respectively?
   a. $23,400 and $27,600.
   b. $24,000 and $27,000.
   c. $24,600 and $26,400.
   d. $26,000 and $25,000.

8. On July 18, 1974, the Amos Corporation granted non-transferable options to certain of its key employees as additional compensation. The options permitted the purchase of 20,000 shares of Amos' common stock at a price of $30 per share. On the date of grant, the market value of the stock was $42 per share. The options were exercisable beginning January 2, 1975, and expire on December 31, 1976. On February 3, 1975, when the stock was selling for $45 per share, all the options were exercised. How much total compensation should Amos record from the issuance of these options?
   a. $240,000.
   b. $300,000.
   c. $840,000.
   d. $900,000.

9. The Motley Company's merchandise inventories and other related accounts for 1974 follow:

Sales	$3,000,000
Cost of goods sold	2,200,000
Merchandise inventory:	
Beginning of year	500,000
End of year	600,000

Assuming that the merchandise-inventory buildup was relatively constant, how many times did the merchandise inventory turn over during 1974?
   a. 4.00.
   b. 4.40.
   c. 5.00.
   d. 5.45.

10. The following data were abstracted from the financial records of the Glum Corporation for 1974:

Sales	$3,600,000
Bond interest expense	120,000
Income taxes	600,000
Net income	800,000

How many times was bond interest earned in 1974?
   a. 6.67.
   b. 7.67.
   c. 11.67.
   d. 12.67.

11. The Chalk Company reported sales of $2,000,000 in 1973 and $3,000,000 in 1974 made evenly throughout each year. The general price-level index during 1972 remained constant at 100, and at the end of 1973 and 1974 it was 102 and 104, respectively. What should Chalk report as sales for 1974, restated for general price-level changes?
   a. $3,000,000.
   b. $3,029,126.
   c. $3,058,821.
   d. $3,120,000.

12. On January 2, 1974, the Mannix Corporation mortgaged one of its properties as collateral for a $1,000,000, 7%, five-year loan. During 1974, the general price level increased evenly, resulting in a 5 percent rise for the year.

In preparing a balance sheet expressing financial position in terms of the general price level at the end of 1974, at what amount should Mannix report its mortgage note payable?

a. $950,000.
b. $1,000,000.
c. $1,025,000.
d. $1,050,000.

13. In January 1970 the Idea Company purchased a patent for a new consumer product for $170,000. At the time of purchase, the patent was valid for seventeen years. Due to the competitive nature of the product, the patent was estimated to have a useful life of ten years. During 1974, the product was removed from the market under governmental order because of a potential health hazard present in the product.

What amount should Idea charge to expense during 1974, assuming amortization is recorded at the end of each year?

a. $10,000.
b. $17,000.
c. $102,000.
d. $130,000.

14. The following information is available for the Hokum Company:

	Amounts in Thousands		
	1972	*1973*	*1974*
Charge sales	$ 900	$1,100	$1,000
Cash sales	600	800	700
Total	$1,500	$1,900	$1,700
Accounts receivable (end of year)	$ 170	$ 230	$ 220
Allowance for doubtful accounts (end of year)	47	30	56
Accounts written off as uncollectible (during the year)	2	50	4

Assuming there was **no** change in the method used for estimating doubtful accounts during 1972-1974, what was the balance in the allowance for doubtful accounts at the beginning of 1972?

a. $0.
b. $22,000.
c. $45,000.
d. $49,000.

15. The Exploitation Company acquired a tract of land containing an extractable natural resource. Exploitation Company is required by its purchase contract to restore the land to a condition suitable for recreational use after it extracts the natural resource. Geological surveys estimate that recoverable reserves will be 3,000,000 tons, and that the land will have a value of $600,000 after restoration. Relevant cost information follows:

Land	$6,000,000
Restoration	900,000
Geological surveys	300,000

If Exploitation Company maintains no inventories of extracted material, what should be the charge to depletion expense per ton of material extracted?

a. $1.80.
b. $1.90.
c. $2.00.
d. $2.20.

Items 16 and 17 are based on the following information:

The Quick Sales Company uses the retail-inventory method to value its merchandise inventory. The following information is available:

	Cost	*Retail*
Beginning inventory	$ 40,000	$ 70,000
Purchases	290,000	400,000
Freight-in	2,000	–
Markups (net)	–	3,000
Markdowns (net)	–	5,000
Employee discounts	–	1,000
Sales	–	390,000

16. What is the ending inventory at retail?

a. $71,000.
b. $72,000.
c. $77,000.
d. $78,000.

17. If the ending inventory is to be valued at the lower of cost or market, what is the cost to retail ratio?

a. $332,000 ÷ $468,000.
b. $332,000 ÷ $472,000.
c. $332,000 ÷ $473,000.
d. $332,000 ÷ $474,000.

Number 2 (Estimated time — 50 to 60 minutes)

Instructions

Select the **best** answer for each of the following items relating to the **federal income taxation of corporations and partnerships.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. The answers should be selected in accordance with the **current Internal Revenue Code and Tax Regulations. Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

18. Eazy Corporation's earnings and profits for 1974, its first year of operations, were $22,000. In December of 1974, it distributed to its individual stockholders, cash of $10,000 and land with a basis of $14,000 and a fair market value of $25,000 at the date of distribution. Prior to the distribution, the stockholders' tax basis of their investment in the corporation was $76,000.

What was the stockholders' adjusted basis at the end of 1974?

a. $51,000.
b. $52,000.
c. $63,000.
d. $74,000.
e. None of the above.

19. Murd Corporation, a domestic corporation, acquired a 90% interest in the Drum Company in 1971 for $30,000. During 1974, the stock of Drum was declared worthless. What type and amount of deduction should Murd take for 1974?

a. Long-term capital loss of $1,000.
b. Long-term capital loss of $15,000.
c. Ordinary loss of $30,000.
d. Long-term capital loss of $30,000.
e. None of the above.

20. Dargent Corporation (not a member of a controlled group) had taxable income of $100,000 for 1974 before special deductions. Included in the $100,000 was $60,000 of cash dividends received from common stock investments in unaffiliated domestic corporations in 1974. Dargent was also entitled to a net operating loss deduction of $8,000. What was Dargent's 1974 taxable income after special deductions?

a. $15,000.
b. $32,000.
c. $40,000.
d. $41,000.
e. None of the above.

21. Sivam Corporation had a net capital loss in 1974 of $62,000. Its net capital gains in the four preceding years were as follows:

1970	$10,000
1971	12,000
1972	28,000
1973	7,000

What amount can Sivam deduct as a net capital loss for 1974?

a. $1,000.
b. $5,000.
c. $15,000.
d $62,000.
e. None of the above.

22. The Benevolent Corporation had taxable income in 1974 of $40,000 before deducting contributions to charitable organizations. During 1974 it gave $5,000 cash to a charitable organization. The company also had a contribution carryover from 1973 of $1,000. What should be the contribution deduction for 1974?

a. $1,000.
b. $1,200.
c. $2,000.
d. $5,000.
e. None of the above.

23. In 1974, the partnership of Al, Gus, and Lew realized an ordinary loss of $90,000. The partnership and partners are on a calendar-year basis. At December 31, 1974, Lew had an adjusted basis of $30,000 for his interest in the partnership before taking the 1974 loss into consideration. Lew has a 40% interest in the profits and losses of the partnership. On his personal income tax return for 1974, what should Lew deduct relative to his partnership interest?

a. An ordinary loss of $30,000.
b. An ordinary loss of $36,000.
c. An ordinary loss of $30,000 and a capital loss of $6,000.
d. A capital loss of $36,000.
e. None of the above.

24. On January 2, 1974, the partnership of Evan and Jared purchased for $80,000 a new machine with an estimated useful life of ten years and a salvage value of $4,000. Evan is married and files a joint return; Jared is single. The profit and loss ratio is Evan, 60%, and Jared, 40%. Neither partner has other business interests. How much additional first-year depreciation is available to the partners for 1974?

a. $3,800.
b. $6,000.
c. $8,000.
d. $15,200.
e. None of the above.

25. The partnership of Bull and Mash had the following items of income during the taxable year ended December 31, 1974:

Net income from sales	$35,000
Dividends from domestic corporations	3,000
Dividends from foreign corporations	2,000
Net long-term capital gain	4,000
Net short-term capital gain	1,000
Net rental income	7,000
	$52,000

What is the total ordinary income of the partnership for 1974?

a. $42,000.
b. $43,000.
c. $44,000.
d. $52,000.
e. None of the above.

Items 26 and 27 are based on the following information:

The Bat Corporation, a calendar-year company, has operated as a Subchapter S corporation for the past four years. At December 31, 1973, the company had undistributed taxable income of $30,000. For the year ended December 31, 1974, it had taxable income and current earnings and profits of $145,000. During 1974, the company made four distributions in cash to its ten equal stockholders who are also on a calendar-year basis. The cash distributions to stockholders were as follows:

January 17, 1974	$15,000
March 11, 1974	20,000
June 12, 1974	25,000
October 14, 1974	30,000
	$90,000

26. For the calendar year 1974, what amount should be included in each stockholder's gross income from Bat?

a. $5,500.
b. $9,000.
c. $14,500.
d. $15,000.
e. None of the above.

27. The basis of one stockholder's stock as of January 1, 1974, was $24,000. What was the basis of his stock on October 1, 1974?

a. $21,000.
b. $32,500.
c. $33,000.
d. $38,500.
e. None of the above.

28. For the year ended December 31, 1974, Fendel Corporation had net income per books of $120,000. Included in determining net income were the following items:

Insurance premiums on the life of the president (company is **not** the beneficiary)	$3,000
Net capital losses	2,200
Penalty for failure to deposit withholding taxes	500
Contributions to charitable organizations	10,000

If all other items included in book income were appropriately includable in the calculation of taxable income, and reasonableness of compensation was **not** at issue, what was Fendel's taxable income for 1974?

a. $107,300.
b. $122,700.
c. $126,065.
d. $128,915.
e. None of the above.

29. During 1974, Hama Corporation exchanged 4,000 shares of its own common stock with a par value of $40,000 for a building with a fair market value of $50,000. For 1974, how much and what type of gain should Hama report on this transaction?

a. No gain.
b. $10,000 capital gain.
c. $10,000 ordinary income.
d. $10,000 Section 1231 gain.
e. None of the above.

30. Which of the following corporations is considered to be an "includable corporation" in an affiliated group of corporations?

a. Holding company.
b. Domestic International Sales Corporation.
c. Real estate investment trust.
d. Regulated investment company.
e. None of the above.

31. Hastings Corporation is an accrual-basis taxpayer. For the year ended December 31, 1974, it had book income before tax of $305,000 after deducting a charitable contribution of $25,000. The contribution was authorized by the board of directors in December 1974, but it was actually paid on March 14, 1975. How should Hastings treat this charitable contribution for tax purposes to minimize its 1974 taxable income?

a. It can do nothing for 1974, but must apply the payment to the 1975 tax year.
b. File a proper election, claim a deduction for 1974 of $15,250, and carry the remainder over a maximum of five succeeding tax years.
c. File a proper election, claim a deduction for 1974 of $16,500, and carry the remainder over a maximum of five succeeding tax years.
d. File a proper election and claim a 1974 deduction of $25,000.
e. None of the above.

32. Brown Corporation's book income for 1974 was $84,000. Organization expenditures of $7,200 incurred at the organization date three years earlier are being amortized over a ten-year period on the financial statements and over the minimum period allowed for tax purposes. Assuming **no** other differences between book and taxable income, what is Brown's taxable income for 1974?

a. $82,460.
b. $83,280.
c. $84,000.
d. $84,720.
e. None of the above.

Number 3 (Estimated time — 40 to 50 minutes)

Your client, Realm Manufacturing, Inc., is planning to issue new bonds at a lower interest rate in order to extinguish currently outstanding bonds. You have been asked to assist with some calculations regarding these transactions.

After reviewing the data of Realm, you realize that this decision to redeem bonds and issue new ones can be viewed as a capital-budgeting decision. When using capital-budgeting techniques, Realm has adopted the following cut-off points: maximum payback period is 8 years and minimum desired rate of return is 16%.

The following data were taken from various interest tables for 15 years at 16% interest:

Present value of an annuity of $1.00 in advance	$6.468
Present value of an annuity of $1.00 in arrears	5.575
Amount of an annuity of $1.00 in arrears	51.660

The following data relate to the original (outstanding) bonds and the new bonds to be issued by Realm:

	Original Bond Issue	*New Bond Issue*
Face value	$20,000,000	$20,000,000
Coupon rate	6%	5%
Call premium	4%	4½%
Expired life	5 years	—
Remaining life to maturity	15 years	15 years
Issued at	98½	100
Total issue costs	$120,000	$135,000

- The new issue is to be sold and then one month later the original issue is to be redeemed. This overlapping month's interest on the original issue is **not** to be considered a miscellaneous cost of reacquisition.
- All discounts and issue costs are amortized on a straight-line basis because that method is not materially different from the "interest" method of amortization. Interest is paid annually.
- All cash flows are assumed to occur at year end.
- The federal income tax rate is 40%.

Required:

a. Compute Realm's accounting gain or loss on the early extinguishment of the original (outstanding) bonds.

b. Compute the net cash investment based on the difference between the net cash outflow to redeem the original issue and the amount raised by the new issue.

c. Compute the net cash benefit per year based on the difference between the annual net cash outlay required on the original issue and the annual net cash outlay required on the new issue.

d. Independent of your answers to **b.** and **c.** above, assume that the net cash investment was $550,000 and that the net cash benefit per year was $120,000. Evaluate this "investment" by using the following capital-budgeting methods:

1. Payback.
2. Present value.

Number 4 (Estimated time — 40 to 50 minutes)

Number 4 consists of two unrelated parts.

Part a. The comptroller of the city of Helmaville recently resigned. In his absence, the deputy comptroller attempted to calculate the amount of money required to be raised from property taxes for the General Fund for the fiscal year ending June 30, 1977. The calculation is to be made as of January 1, 1976, to serve as a basis for setting the property tax rate for the following fiscal year. The mayor has requested you to review the deputy comptroller's calculations and obtain other necessary information to prepare a formal statement for the General Fund which will disclose the amount of money required to be raised from property taxes for the fiscal year ending June 30, 1977. Following are the calculations prepared by the deputy comptroller:

City resources other than proposed tax levy:	
Estimated General Fund working balance, January 1, 1976	$ 352,000
Estimated receipts from property taxes (January 1, 1976 – June 30, 1976)	2,222,000
Estimated revenue from investments (January 1, 1976 – June 30, 1977)	442,000
Estimated proceeds from sale of general obligation bonds in August 1976	3,000,000
	$6,016,000
General Fund requirements:	
Estimated expenditures (January 1, 1976 – June 30, 1976)	$1,900,000
Proposed appropriations (July 1, 1976 – June 30, 1977)	4,300,000
	$6,200,000

Additional information:

- The General Fund working balance required by the city council for July 1, 1977, is $175,000.
- Property tax collections are due in March and September of each year. Your review indicates that during the month of February 1976 estimated expenditures will exceed available funds by $200,000. Pending collection of property taxes in March 1976, this deficiency will have to be met by the issuance of thirty-day tax-anticipation notes of $200,000 at an estimated interest rate of 9% per annum.
- The proposed general obligation bonds will be issued by the City Water Fund and will be used for the construction of a new water pumping station.

Required:

Prepare a statement as of January 1, 1976, calculating the property tax levy required for the City of Helmaville General Fund for the fiscal year ending June 30, 1977.

Part b. In compliance with a newly enacted state law, Dial County assumed the responsibility of collecting all property taxes levied within its boundaries as of July 1, 1975. A composite property tax rate per $100 of net assessed valuation was developed for the fiscal year ending June 30, 1976, and is presented below:

Dial County General Fund	$ 6.00
Eton City General Fund	3.00
Bart Township General Fund	1.00
	$10.00

All property taxes are due in quarterly installments and when collected are then distributed to the governmental units represented in the composite rate.

In order to administer collection and distribution of such taxes, the County has established a Tax Agency Fund.

Additional information:

- In order to reimburse the County for estimated administrative expenses of operating the Tax Agency Fund, the Tax Agency Fund is to deduct 2 percent from the tax collections each quarter for Eton City and Bart Township. The total amount deducted is to be remitted to the Dial County General Fund.
- Current year tax levies to be collected by the Tax Agency Fund are as follows:

	Gross Levy	*Estimated Amount to be Collected*
Dial County	$3,600,000	$3,500,000
Eton City	1,800,000	1,740,000
Bart Township	600,000	560,000
	$6,000,000	$5,800,000

- $10,000 was charged back to Bart Township because of an error in the original computation of its current gross tax levy and the estimated amount to be collected.
- As of September 30, 1975, the Tax Agency Fund has received $1,440,000 in first quarter payments. On October 1, this Fund made a distribution to the three governmental units.

Required:

For the period July 1, 1975, through October 1, 1975, prepare journal entries to record the transactions described above for the following funds:

Dial County Tax Agency Fund
Dial County General Fund
Eton City General Fund
Bart Township General Fund

Your answer sheet should be organized as follows:

Accounts	*Dial County Tax Agency Fund*		*Dial County General Fund*		*Eton City General Fund*		*Bart Township General Fund*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*

Number 5 (Estimated time — 50 to 60 minutes)

Condensed Statements of Income and Retained Earnings of The Salem Company for the years ended December 31, 1974, and December 31, 1973, are presented below:

The Salem Company
CONDENSED STATEMENTS OF INCOME AND RETAINED EARNINGS

	Years Ended December 31, 1974	1973
Sales	$3,000,000	$2,400,000
Cost of goods sold	1,300,000	1,150,000
Gross margin	1,700,000	1,250,000
Selling, general, and administrative expenses	1,200,000	950,000
Income before extraordinary item	500,000	300,000
Extraordinary item	(400,000)	–
Net income	100,000	300,000
Retained earnings, January 1	750,000	450,000
Retained earnings, December 31	$ 850,000	$ 750,000

Presented below are four **unrelated** situations involving accounting changes and classification of certain items as ordinary or extraordinary. Each situation is based upon the Condensed Statements of Income and Retained Earnings of The Salem Company shown above and requires revisions to these statements.

Situation A

- On January 1, 1972, Salem acquired machinery at a cost of $150,000. The company adopted the double-declining-balance method of depreciation for this machinery, and had been recording depreciation over an estimated life of ten years, with no residual value. At the beginning of 1974, a decision was made to adopt the straight-line method of depreciation for this machinery. Due to an oversight, however, the double-declining-balance method was used for 1974. For financial-reporting purposes, depreciation is included in selling, general, and administrative expenses.
- The extraordinary item in the Condensed Statement of Income and Retained Earnings for 1974 relates to shutdown expenses incurred by the company during a major strike by its operating employees during 1974.

Situation B

- At the end of 1974, Salem's management decided that the estimated loss rate on uncollectible accounts receivables was too low. The loss rate used for the years 1973 and 1974 was 1% of total sales, and due to an increase in the write off of uncollectible accounts, the rate has been raised to 3% of total sales. The amount recorded in bad debt expense under the heading of selling, general, and administrative expenses for 1974 was $30,000 and for 1973 was $24,000.
- The extraordinary item in the Condensed Statement of Income and Retained Earnings for 1974 relates to a loss incurred in the abandonment of outmoded equipment formerly used in the business.

Situation C

- On December 2, 1974, Salem issued 100,000 shares of its $1 par value common stock in exchange for 100,000 shares of $1 par value (100%) voting common stock of Arco Corporation in a transaction to be properly accounted for as a pooling of interests. The Condensed Statements of Income and Retained Earnings of Salem shown above do **not** include Arco's operations. A summary of Arco's financial operations for the years 1974, 1973, and 1972 follows:

	1974	*1973*	*1972*
Sales	$600,000	$520,000	$410,000
Cost of goods sold	274,000	238,000	195,000
Gross margin	326,000	282,000	215,000
Selling, general, and administrative expenses	219,000	190,000	165,000
Net income	107,000	92,000	50,000
Retained earnings (Deficit), January 1	72,000	(20,000)	(70,000)
Retained earnings (Deficit), December 31	$179,000	$ 72,000	$ (20,000)

- The extraordinary item in the Condensed Statement of Income and Retained Earnings for 1974 relates to a loss sustained as a result of damage caused by a tornado to the company's merchandise at its main warehouse in Locust City. This natural disaster was considered to be an unusual and infrequent occurrence for that geographic section of the country.

Situation D

- The extraordinary item appearing in the Condensed Statement of Income and Retained Earnings for 1974 relates to a settlement agreement between Salem and the Internal Revenue Service in which Salem was assessed and agreed to pay additional income taxes of $60,000 for 1973 and $340,000 for the years 1969-1972.

Required:
For each of the four **unrelated** situations, prepare revised Condensed Statements of Income and Retained Earnings of The Salem Company on the worksheet (p.182) for the years ended December 31, 1974, and December 31, 1973. Each answer should recognize the appropriate accounting changes and other items outlined in the situation. **Ignore income tax considerations unless indicated to the contrary. Ignore all earnings per share computations and all pro forma computations.**

The Salem Company

CONDENSED STATEMENTS OF INCOME AND RETAINED EARNINGS

For the Years Ended December 31, 1974 and 1973

(Required for Number 5)

	Situation A		*Situation B*		*Situation C*		*Situation D*	
	1974	*1973*	*1974*	*1973*	*1974*	*1973*	*1974*	*1973*
Sales	$3,000,000	$2,400,000	$3,000,000	$2,400,000	$	$	$3,000,000	$2,400,000
Cost of goods sold	1,300,000	1,150,000	1,300,000	1,150,000			1,300,000	1,150,000
Gross margin	1,700,000	1,250,000	1,700,000	1,250,000			1,700,000	1,250,000
Selling, general, and administrative expenses								
Income before extraordinary item and accounting changes								
Extraordinary item								
Net income								
Retained earnings, January 1								
Retained earnings, December 31	$	$	$	$	$	$	$	$

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN AUDITING

November 6, 1975; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	30	35
No. 2	30	35
No. 3	30	35
No. 4	20	25
No. 5	20	25
No. 6	20	25
No. 7	20	30
Total for examination	170	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time -- 30 to 35 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

96. One of the generally accepted auditing standards specifies that the auditor
   a. Inspect all fixed assets acquired during the year.
   b. Charge fair fees based on cost.
   c. Make a proper study and evaluation of the existing internal control.
   d. May not solicit clients.

Answer Sheet

96. a. :::::::::: b. :::::::::: c. ▬▬ d. ::::::::::

Items to be Answered

1. Loeb, CPA, has completed a review of the Bloto Company's unaudited financial statements and has prepared the following report to accompany them:

> The accompanying balance sheet of the Bloto Company as of August 31, 1975, and the related statements of income, retained earnings, and changes in financial position for the year then ended were not audited by us and accordingly we do not express an opinion on them.
>
> The financial statements fail to disclose that the debentures issued on July 15, 1972, limit the payment of cash dividends to the amount of earnings after August 31, 1973. The company's statements of income for the years 1974 and 1975, both of which are unaudited, show this amount to be \$18,900. Generally accepted accounting principles require disclosure of matters of this nature.

Which of the following comments **best** describes the appropriateness of this report?
   a. The report is satisfactory.
   b. The report is deficient because Loeb does not describe the scope of the review.
   c. The report is deficient because the second paragraph gives the impression that some audit work was done.
   d. The report is deficient because the explanatory comment in the second paragraph should precede the opinion paragraph.

Items 2 and 3 are based on the following information:

Ansman, CPA, has been requested by a client, Rainco Corp., to prepare a "long-form report" for this year's audit engagement.

2. Which of the following is the **best** reason for Rainco's requesting a long-form report?
   a. To provide for a piecemeal opinion because certain items are not in accordance with generally accepted accounting principles.
   b. To provide Rainco's creditors a greater degree of assurance as to the financial soundness of the company.
   c. To provide Rainco's management with information to supplement and analyze the basic financial statements.
   d. To provide the documentation required by the Securities and Exchange Commission in anticipation of a public offering of Rainco's stock.

3. In issuing a long-form report, Ansman must be certain to
   a. Issue a standard short-form report on the same engagement.
   b. Include a description of the scope of the examination in more detail than the description in the usual short-form report.
   c. State the source of any statistical data and that such data have not been subjected to the same auditing procedures as the basic financial statements.
   d. Maintain a clear-cut distinction between the management's representations and the auditor's representations.

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4. A CPA should **not** normally refer to which one of the following subjects in a "comfort letter" to underwriters?
   a. The independence of the CPA.
   b. Changes in financial-statement items during a period subsequent to the date and period of the latest financial statements in the registration statement.
   c. Unaudited financial statements and schedules in the registration statement.
   d. Management's determination of line of business classifications.

5. The consistency standard does **not** apply to an accounting change that results from a change in
   a. Accounting principle.
   b. Accounting estimate.
   c. The reporting entity.
   d. Accounting principle inseparable from a change in accounting estimate.

6. Which of the generally accepted auditing standards of reporting would **not** normally apply to special reports such as cash-basis statements?
   a. First standard.
   b. Second standard.
   c. Third standard.
   d. Fourth standard.

7. In a "comfort letter" to underwriters, the CPA should normally avoid using which of the following terms to describe the work performed?
   a. Examined.
   b. Read.
   c. Made inquiries.
   d. Made a limited review.

8. Jeffries, CPA, had prepared unaudited financial statements for a client, the Gold Company. Since the statements were only to be used internally by the client, Jeffries did **not** include any footnotes and so noted this in the accompanying disclaimer of opinion. Three months after the statements were issued, the Gold Company asked Jeffries if it would be all right to give a copy of the statements to its banker who had requested financial statements. How should Jeffries respond?
   a. Jeffries should revise the statements to include appropriate footnotes and attach a revised disclaimer of opinion before they are released to the banker.
   b. Gold may give the statements to the banker as long as Jeffries' disclaimer of opinion accompanies the statements.
   c. Gold should retype the statements on plain paper and send them to the banker without Jeffries' report.
   d. Gold may let the banker review the statements and take notes but should not give the banker a copy of the statements.

9. The following statements were made in a discussion of audit evidence between two CPAs. Which statement is **not** valid concerning evidential matter?
   a. "I am seldom convinced beyond all doubt with respect to all aspects of the statements being examined."
   b. "I would not undertake that procedure because at best the results would only be persuasive and I'm looking for convincing evidence."
   c. "I evaluate the degree of risk involved in deciding the kind of evidence I will gather."
   d. "I evaluate the usefulness of the evidence I can obtain against the cost to obtain it."

10. When compared to the auditor of fifty years ago, today's auditor places **less** relative emphasis upon
   a. Confirmation.
   b. Examination of documentary support.
   c. Overall tests of ratios and trends.
   d. Physical observation.

11. Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor. Which of the following is an example of corroborating information?
   a. Minutes of meetings.
   b. General and subsidiary ledgers.
   c. Accounting manuals.
   d. Worksheets supporting cost allocations.

12. Although the validity of evidential matter is dependent on the circumstances under which it is obtained, there are three general presumptions which have some usefulness. The situations given below indicate the relative reliability a CPA has placed on two types of evidence obtained in different situations. Which of these is an **exception** to one of the general presumptions?
   a. The CPA places more reliance on the balance in the scrap sales account at plant A where the CPA has made limited tests of transactions because of good internal control than at plant B where the CPA has made extensive tests of transactions because of poor internal control.
   b. The CPA places more reliance on the CPA's computation of interest payable on outstanding bonds than on the amount confirmed by the trustee.
   c. The CPA places more reliance on the report of an expert on an inventory of precious gems than on the CPA's physical observation of the gems.
   d. The CPA places more reliance on a schedule of insurance coverage obtained from the company's insurance agent than on one prepared by the internal audit staff.

13. What is the objective of the reporting standard relating to consistency?
   a. To give assurance that adequate disclosure will be made so that there will be comparability of financial statements between companies in the same industry.
   b. To give assurance that the comparability of financial statements between periods has not been materially affected by changes in accounting principles.
   c. To give assurance that the comparability of financial statements between periods has not been materially affected by any change.
   d. To give assurance only that the same accounting principles have been applied to all similar transactions within each period presented.

14. Which of the following is the **least** important factor a CPA should consider in determining whether financial statements with which the CPA is associated may be issued as unaudited?
   a. The restrictions a client might place on observing inventories or confirming receivables.
   b. The intended use of the financial statements.
   c. The procedures actually performed.
   d. The needs of the client.

15. What recognition, if any, should be given to an accounting change which has **no** material effect on the financial statements in the current year but the change is reasonably certain to have substantial effect in later years?
   a. There is no need for recognition because when the change was made it had no material effect.
   b. The change should be disclosed in the notes to the financial statements whenever the statements of the year of change are presented, but the CPA need not recognize the change in the CPA's opinion as to consistency.
   c. The change should be disclosed in the notes to the financial statements whenever the statements of the year of change are presented and the CPA must recognize the change in the CPA's opinion as to consistency.
   d. The change should be recognized in the CPA's opinion as to consistency only when it is not disclosed in notes to the financial statements.

16. The ordinary examination of financial statements is **not** primarily designed to disclose defalcations and other irregularities although their discovery may result. Normal audit procedures are more likely to detect a fraud arising from
   a. Collusion on the part of several employees.
   b. Failure to record cash receipts for services rendered.
   c. Forgeries on company checks.
   d. Theft of inventories.

17. Auditing standards differ from auditing procedures in that procedures relate to
   a. Measures of performance.
   b. Audit principles.
   c. Acts to be performed.
   d. Audit judgments.

Items 18, 19, and 20 are based on the following information:

A CPA has completed an annual audit. The client has requested a report on internal control which it intends to submit to a regulatory agency. The CPA has drafted the first three paragraphs of the report on internal control which are presented in items 18, 19, and 20, respectively. Each paragraph contains a deficiency or inappropriate statement. Each sentence or part thereof of each paragraph (items 18, 19, and 20) corresponds to a response – a, b, c, and d.

Select the response (a, b, c, or d) in each (items 18, 19, and 20) that corresponds to the sentence or part thereof which contains the **deficiency** or **inappropriate** statement.

18. First paragraph:
   a. We have examined the financial statements of ABC Company and have issued our report thereon.
   b. As a part of our examination, we reviewed and tested the Company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards.
   c. Under these standards the purpose of such evaluation is to establish a basis for reliance thereon . . .
   d. . . . in determining the nature, timing, and extent of other auditing procedures that are necessary for expressing an opinion on the financial statements.

19. Second paragraph:
   a. The objective of internal accounting control is to provide reasonable, but not absolute, assurance as to the safeguarding of assets against loss from unauthorized use or disposition, . . .
   b. . . . and the reliability of financial records for preparing financial statements and maintaining accountability for assets.
   c. The concept of reasonable assurance recognizes that the cost of an effective system of internal accounting control may often have to exceed the benefits derived, . . .
   d. . . . and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management.

20. Third paragraph:
   a. There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control.
   b. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends upon segregation of duties can be circumvented by collusion.
   c. Similarly, control procedures can be circumvented intentionally by management with respect either to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements.
   d. Further, projection of any evaluation of internal accounting control should not extend beyond the next fiscal year because, beyond that period, changed conditions and the degree of compliance with the procedures could materially weaken the overall system of internal control.

Number 2 (Estimated time -- 30 to 35 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

21. A CPA should **not** issue a report on internal control if
    a. The report is to be sent to stockholders with unaudited interim financial statements.
    b. The CPA has not audited the company's financial statements.
    c. The report is to be given to creditors.
    d. The report is to be given to prospective investors.

22. Dey, Knight, & Co., CPAs, has issued a qualified opinion on the financial statements of Adams, Inc., because of a scope limitation. Adams, Inc., requested a report on internal control which it intends to give to one of its major creditors. What effect, if any, would the qualified opinion have on the internal control report that Dey, Knight, & Co. intends to prepare based on its audit engagement?
    a. The audit scope limitation should be indicated in the report on internal control.
    b. A report on internal control cannot be issued based on a qualified opinion.
    c. The audit scope limitation has no effect but Dey, Knight, & Co. should not issue the report if it will be given to a creditor.
    d. The audit scope limitation has no effect on a report on internal control.

23. A client has a calendar year end. Listed below are four events that occurred after December 31. Which one of these subsequent events might result in adjustment of the December 31 financial statements?
    a. Adoption of accelerated depreciation methods.
    b. Write-off of a substantial portion of inventory as obsolete.
    c. Collection of 90% of the accounts receivable existing at December 31.
    d. Sale of a major subsidiary.

24. The auditor's formal review of subsequent events normally should be extended through the date of the
    a. Auditor's report.
    b. Next formal interim financial statements.
    c. Delivery of the audit report to the client.
    d. Mailing of the financial statements to the stockholders.

25. On August 5, 1975, a CPA completed field work on a client's financial statements for the year ended June 30, 1975. On August 20, 1975, the anticipated date for delivery of the report, the CPA read in the paper that one of the client's plants burned to the ground. The CPA calls the client to confirm the information and tells the client this subsequent event should be disclosed in the financial statements. The client agrees to add a footnote but still needs the report today. The CPA quickly revises the statements by adding a "Note G" and delivers the report on time. What date should the report bear?
    a. August 5, 1975.
    b. August 5, 1975, except for Note G which is August 20, 1975.
    c. August 20, 1975.
    d. June 30, 1975.

26. A registration statement filed with the Securities and Exchange Commission may contain the reports of two or more independent auditors on their examinations of the financial statements for different periods. What responsibility does the auditor who has **not** examined the most recent financial statements have relative to subsequent events which may affect the financial statements on which the auditor reported?
    a. The auditor has responsibility for events up to the subsequent fiscal year end.
    b. The auditor has responsibility for events up to the date of the subsequent audit report.
    c. The auditor has responsibility for events up to the effective date of the registration statement.
    d. The auditor has no responsibility beyond the date of his original report.

27. How should an auditor determine the precision required in establishing a statistical sampling plan?
    a. By the materiality of an allowable margin of error the auditor is willing to accept.
    b. By the amount of reliance the auditor will place on the results of the sample.
    c. By reliance on a table of random numbers.
    d. By the amount of risk the auditor is willing to take that material errors will occur in the accounting process.

28. In testing the payroll of a large company, the auditor wants to establish that the individuals included in a sample actually were employees of the company during the period under review. What will be the **best** source to determine this?
    a. Telephone contacts with the employees.
    b. Tracing from the payroll register to the employees' earnings records.
    c. Confirmation with the union or other independent organization.
    d. Examination of personnel department records.

29. Which of the following is an advantage of systematic sampling over random number sampling?
   a. It provides a stronger basis for statistical conclusions.
   b. It enables the auditor to use the more efficient "sampling with replacement" tables.
   c. There may be correlation between the location of items in the population, the feature of sampling interest, and the sampling interval.
   d. It does not require establishment of correspondence between random numbers and items in the population.

30. An auditor makes separate compliance and substantive tests in the accounts payable area which has good internal control. If the auditor uses statistical sampling for both of these tests, the confidence level established for the substantive test is normally
   a. The same as that for tests of compliance.
   b. Greater than that for tests of compliance.
   c. Less than that for tests of compliance.
   d. Totally independent of that for tests of compliance.

Items 31 and 32 are based on the following information:

Green, a CPA not in public practice, is an employee in the internal audit department of Bigg Conglomerate Company. The management has asked Green to perform examinations of potential acquisitions and to express an opinion thereon. Bigg will use the reports for internal purposes and to show to its bankers in accordance with certain loan agreements. Your response to items 31 and 32 should be based on the AICPA Code of Professional Ethics.

31. How should Green sign the report?
   a. Green, CPA.
   b. Green, Internal Auditor.
   c. Green, CPA (Internal Auditor).
   d. Green, Internal Auditor (CPA).

32. If Green performed the same examination as would have been done by the outside auditors, what difference should there be in the opinion Green would render?
   a. None.
   b. Green should not refer to generally accepted auditing standards.
   c. Green should qualify his opinion based on lack of independence.
   d. Green should disclaim an opinion based on lack of independence.

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33. An example of sampling for attributes would be estimating the
   a. Quantity of specific inventory items.
   b. Probability of losing a patent infringement case.
   c. Percentage of overdue accounts receivable.
   d. Dollar value of accounts receivable.

34. The cashier of Safir Company covered a shortage in the cash working fund with cash obtained on December 31 from a local bank by cashing but not recording a check drawn on the Company's out-of-town bank. How would the auditor discover this manipulation?
   a. Confirming all December 31 bank balances.
   b. Counting the cash working fund at the close of business on December 31.
   c. Preparing independent bank reconciliations as of December 31.
   d. Investigating items returned with the bank cut-off statements.

35. Statements on Auditing Standards issued by the AICPA's Auditing Standards Executive Committee are
   a. Part of the generally accepted auditing standards under the AICPA Code of Professional Ethics.
   b. Interpretations of generally accepted auditing standards under the AICPA Code of Professional Ethics, and departures from such statements must be justified.
   c. Interpretations of generally accepted auditing standards under the AICPA Code of Professional Ethics, and such statements must be followed in every engagement.
   d. Generally accepted auditing procedures that are not covered by the AICPA Code of Professional Ethics.

36. Reed, a partner in a local CPA firm, performs free accounting services for a private club of which Reed is treasurer. Which of the following would be the most preferable manner for Reed to issue the financial statements of the club?
   a. On the firm's letterhead with a disclaimer for lack of independence.
   b. On the firm's letterhead with a disclaimer for unaudited financial statements.
   c. On plain paper with no reference to Reed so that Reed will not be associated with the statements.
   d. On the club's letterhead with Reed signing as treasurer.

37. Upon discovering irregularities in a client's tax return that the client would **not** correct, a CPA withdraws from the engagement. How should the CPA respond if asked by the successor CPA why the relationship was terminated?
   a. "It was a misunderstanding."
   b. "I suggest you get the client's permission for us to discuss all matters freely."
   c. "I suggest you ask the client."
   d. "I found irregularities in the tax return which the client would not correct."

38. An auditor is testing sales transactions. One step is to trace a sample of debit entries from the accounts receivable subsidiary ledger back to the supporting sales invoices. What would the auditor intend to establish by this step?
    a. All sales have been recorded.
    b. Debit entries in the accounts receivable subsidiary ledger are properly supported by sales invoices.
    c. All sales invoices have been properly posted to customer accounts.
    d. Sales invoices represent bona fide sales.

39. In a manufacturing company, which one of the following audit procedures would give the **least** assurance of the validity of the general ledger balance of investment in stocks and bonds at the audit date?
    a. Confirmation from the broker.
    b. Inspection and count of stocks and bonds.
    c. Vouching all changes during the year to brokers' advices and statements.
    d. Examination of paid checks issued in payment of securities purchased.

40. Which of the following publications does **not** qualify as a statement of generally accepted accounting principles under the AICPA Code of Professional Ethics?
    a. AICPA Accounting Research Bulletins and APB Opinions.
    b. Accounting interpretations issued by the AICPA.
    c. Statements of Financial Standards issued by the FASB.
    d. Accounting interpretations issued by the FASB.

Number 3 (Estimated time –– 30 to 35 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

41. A CPA is conducting the first examination of a nonpublic company's financial statements. The CPA hopes to reduce the audit work by consulting with the predecessor auditor and reviewing the predecessor's working papers. This procedure is
    a. Acceptable if the client and the predecessor auditor agree to it.
    b. Acceptable if the CPA refers in the audit report to reliance upon the predecessor auditor's work.
    c. Required if the CPA is to render an unqualified opinion.
    d. Unacceptable because the CPA should bring an independent viewpoint to a new engagement.

42. Below are the names of four CPA firms and pertinent facts relating thereto. Unless otherwise indicated, the individuals named are CPAs and partners, and there are **no** other partners. Which firm name and related facts indicate a violation of the AICPA Code of Professional Ethics?
    a. Green, Lawrence, and Craig, CPAs (Craig died about five years ago; Green and Lawrence are continuing the firm).
    b. Clay and Sharp, CPAs (The name of Andy Randolph, CPA, a third active partner, is omitted from the firm name).
    c. Fulton and Jackson, CPAs (Jackson died about three years ago; Fulton is continuing the firm as a sole proprietorship).
    d. Schneider & Co., CPAs, Inc. (The firm has ten other stockholders who are all CPAs).

43. In forming an opinion on the consolidated financial statements of Albom Corp., a CPA relies upon another auditor's examination of the financial statements of Henig Company, a wholly owned subsidiary. Henig's auditor expressed an unqualified opinion. In the report on Albom's consolidated financial statements the CPA expresses an unqualified opinion and refers to the other auditor's examination. This indicates that
    a. The CPA concludes, based upon a review of the other auditor's work, that the same responsibility can be assumed as though the CPA had audited Henig.
    b. The CPA is satisfied with the other auditor's work in general but has some reservation relating to that auditor's independence or professional standing.
    c. The CPA's review of the subsidiary's financial statements indicates a problem that may have escaped the other auditor.
    d. The CPA is satisfied with the other auditor's independence and professional standing but is unwilling to take responsibility for his work.

44. A principal auditor decides to assume responsibility for the work of another CPA insofar as the other CPA's work relates to the principal auditor's expression of an opinion on the financial statements taken as a whole. The opinion of the other CPA is qualified but the subject of the qualification is **not** material in relation to the financial statements taken as a whole. In discharging the reporting obligation, the principal auditor
    a. Must qualify his opinion.
    b. Must make reference to the other CPA's qualified opinion and state that it is not material to the financial statements taken as a whole.
    c. Need not make reference in the report to the qualification, but must disclose, in a note to the financial statements, the subject of the qualification and its effect on financial position, results of operations, and changes in financial position.
    d. Need not make reference in the report to the qualification.

45. When comparative financial statements are presented and a change in accounting principle is made in the current year, the financial statements of the prior year should be restated **except** when the change is
   a. From the completed contract to the percentage of completion method of accounting for long-term construction-type contracts.
   b. From the LIFO to the FIFO method of inventory pricing.
   c. From the FIFO to the LIFO method of inventory pricing.
   d. From the "full cost" to another acceptable method of accounting which is used in the extractive industry.

46. A CPA who has given correct tax advice which is later affected by changes in the tax law is **required** to
   a. Notify the client upon learning of any change.
   b. Notify the client only when the CPA is actively assisting with implementing the advice or is obliged to so notify by specific agreement.
   c. Notify the Internal Revenue Service.
   d. Take no action if the client has already followed the advice unless the client asks the question again.

47. As generally conceived, the "audit committee" of a publicly held company should be made up of
   a. Representatives of the major equity interests (bonds, preferred stock, common stock).
   b. The audit partner, the chief financial officer, the legal counsel, and at least one outsider.
   c. Representatives from the client's management, investors, suppliers, and customers.
   d. Members of the board of directors who are not officers or employees.

48. Evaluation of the electronic data processing aspects of a system of accounting control should
   a. Not be a part of the auditor's evaluation of the system.
   b. Be a separate part of the auditor's evaluation of the system.
   c. Be an integral part of the auditor's evaluation of the system.
   d. Be coordinated with the auditor's evaluation of administrative control.

49. Which of the following audit procedures is the **most** appropriate when internal control over cash is weak or when a client requests an investigation of cash transactions?
   a. Proof of cash.
   b. Bank reconciliation.
   c. Cash confirmation.
   d. Evaluate ratio of cash to current liabilities.

50. Audit programs generally include procedures necessary to test actual transactions and resulting balances. These procedures are **primarily** designed to
   a. Detect irregularities that result in misstated financial statements.
   b. Test the adequacy of internal control.
   c. Gather corroborative evidence.
   d. Obtain information for informative disclosures.

51. When conducting an audit, errors that arouse suspicion of fraud should be given greater attention than other errors. This is an example of applying the criterion of
   a. Reliability of evidence.
   b. Materiality.
   c. Relative risk.
   d. Dual-purpose testing.

52. Independent auditing can **best** be described as
   a. A branch of accounting.
   b. A discipline which attests to the results of accounting and other functional operations and data.
   c. A professional activity that measures and communicates financial and business data.
   d. A regulatory function that prevents the issuance of improper financial information.

53. An independent audit aids in the communication of economic data because the audit
   a. Confirms the accuracy of management's financial representations.
   b. Lends credibility to the financial statements.
   c. Guarantees that financial data are fairly presented.
   d. Assures the readers of financial statements that any fraudulent activity has been corrected.

54. The primary purpose of internal control relating to heavy equipment is
   a. To ascertain that the equipment is properly maintained.
   b. To prevent theft of the equipment.
   c. To determine when to replace the equipment.
   d. To promote operational efficiency of the dollars invested in the equipment.

55. Which of the following should **not** be treated as an accounting change that affects the standard of reporting relating to consistency?
   a. Change in the service lives of all assets.
   b. Change from cash basis to accrual method of accounting.
   c. Change from FIFO to LIFO inventory method.
   d. Change from straight-line to declining-balance method of depreciation.

56. A CPA is reporting on the consolidated financial statements of a company which has a significant subsidiary which is audited by another CPA. Which of the following procedures is **unnecessary** if the first CPA plans to refer in his report to the report of the other CPA?
    a. Obtain a representation from the other CPA that such CPA is independent under the requirements of the American Institute of Certified Public Accountants.
    b. Ascertain through communication with the other CPA that such CPA is aware that the financial statements of the subsidiary will be included in the consolidated financial statements.
    c. Ascertain through communication with the other CPA that a review will be made of matters affecting elimination of intercompany transactions and accounts.
    d. Visit the other CPA and discuss the audit procedures followed and results thereof.

57. A CPA who is **not** independent and is associated with financial statements should disclaim an opinion with respect to those financial statements. The disclaimer should
    a. Clearly state the specific reasons for lack of independence.
    b. Not mention any reason for the disclaimer other than that the CPA was unable to conduct the examination in accordance with generally accepted auditing standards.
    c. Not describe the reason for lack of independence but should state specifically that the CPA is not independent.
    d. Include a middle paragraph clearly describing the CPA's association with the client and explaining why the CPA was unable to gather sufficient competent evidential matter to warrant the expression of an opinion.

58. Before relying on the system of internal control, the auditor obtains a reasonable degree of assurance that the internal control procedures are in use and operating as planned. The auditor obtains this assurance by performing
    a. Substantive tests.
    b. Transaction tests.
    c. Compliance tests.
    d. Tests of trends and ratios.

59. Which of the following activities would be **least** likely to strengthen a company's internal control?
    a. Separating accounting from other financial operations.
    b. Maintaining insurance for fire and theft.
    c. Fixing responsibility for the performance of employee duties.
    d. Carefully selecting and training employees.

60. The most significant aspect of the Continental Vending case was that it
    a. Created a more general awareness of the auditor's exposure to criminal prosecution.
    b. Extended the auditor's responsibility for financial statements of subsidiaries.
    c. Extended the auditor's responsibility for events after the end of the audit period.
    d. Defined the auditor's common law responsibilities to third parties.

Number 4 (Estimated time –– 20 to 25 minutes)

Upon completion of all field work on September 23, 1975, the following "short-form" report was rendered by Timothy Ross to the directors of The Rancho Corporation.

To the Directors of
The Rancho Corporation:

We have examined the balance sheet and the related statement of income and retained earnings of The Rancho Corporation as of July 31, 1975. In accordance with your instructions, a complete audit was conducted.

In many respects, this was an unusual year for The Rancho Corporation. The weakening of the economy in the early part of the year and the strike of plant employees in the summer of 1975 led to a decline in sales and net income. After making several tests of sales records, nothing came to our attention that would indicate that sales have not been properly recorded.

In our opinion, with the explanation given above, and with the exception of some minor errors that are considered immaterial, the aforementioned financial statements present fairly the financial position of The Rancho Corporation at July 31, 1975, and the results of its operations for the year then ended, in conformity with pronouncements of the Accounting Principles Board and the Financial Accounting Standards Board applied consistently throughout the period.

Timothy Ross, CPA
September 23, 1975

Required:

List and explain deficiencies and omissions in the auditor's report. The type of opinion (unqualified, qualified, adverse, or disclaimer) is of no consequence and need not be discussed.

Organize your answer sheet by paragraph (scope, explanatory, and opinion) of the auditor's report.

Number 5 (Estimated time — 20 to 25 minutes)

A CPA's client, Boos & Baumkirchner, Inc., is a medium-sized manufacturer of products for the leisure time activities market (camping equipment, scuba gear, bows and arrows, etc.). During the past year, a computer system was installed, and inventory records of finished goods and parts were converted to computer processing. The inventory master file is maintained on a disc. Each record of the file contains the following information:

Item or part number
Description
Size
Unit of measure code
Quantity on hand
Cost per unit
Total value of inventory on hand at cost
Date of last sale or usage
Quantity used or sold this year
Economic order quantity
Code number of major vendor
Code number of secondary vendor

In preparation for year-end inventory the client has two identical sets of preprinted inventory count cards. One set is for the client's inventory counts and the other is for the CPA's use to make audit test counts. The following information has been keypunched into the cards and interpreted on their face:

- Item or part number
- Description
- Size
- Unit of measure code

In taking the year-end inventory, the client's personnel will write the actual counted quantity on the face of each card. When all counts are complete, the counted quantity will be keypunched into the cards. The cards will be processed against the disc file, and quantity-on-hand figures will be adjusted to reflect the actual count. A computer listing will be prepared to show any missing inventory count cards and all quantity adjustments of more than $100 in value. These items will be investigated by client personnel, and all required adjustments will be made. When adjustments have been completed, the final year-end balances will be computed and posted to the general ledger.

The CPA has available a general purpose computer audit software package that will run on the client's computer and can process both card and disc files.

Required:

a. In general and without regard to the facts above, discuss the nature of general purpose computer audit software packages and list the various types and uses of such packages.

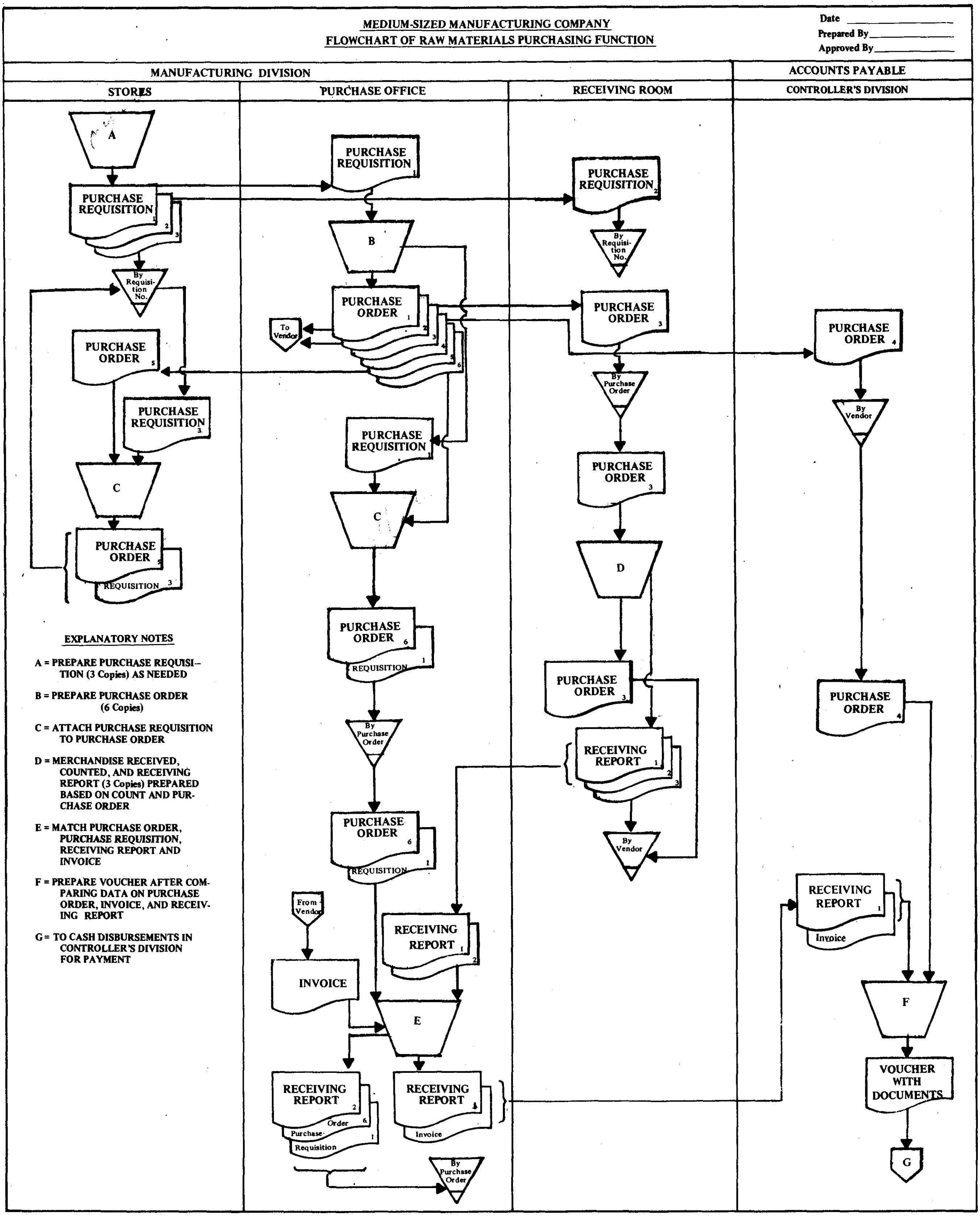
b. List and describe at least five ways a general purpose computer audit software package can be used to assist in all aspects of the audit of the inventory of Boos & Baumkirchner, Inc. (For example, the package can be used to read the disc inventory master file and list items and parts with a high unit cost or total value. Such items can be included in the test counts to increase the dollar coverage of the audit verification).

Number 6 (Estimated time — 20 to 25 minutes)

Anthony, CPA, prepared the flowchart on the facing page which portrays the raw materials purchasing function of one of Anthony's clients, a medium-sized manufacturing company, from the preparation of initial documents through the vouching of invoices for payment in accounts payable. The flowchart was a portion of the work performed on the audit engagement to evaluate internal control.

Required:

Identify and explain the systems and control weaknesses evident from the flowchart on the facing page. Include the internal control weaknesses resulting from activities performed or not performed. All documents are prenumbered.


MEDIUM-SIZED MANUFACTURING COMPANY
FLOWCHART OF RAW MATERIALS PURCHASING FUNCTION
Date
Prepared By
Approved By
MANUFACTURING DIVISION
ACCOUNTS PAYABLE
STORES
PURCHASE OFFICE
RECEIVING ROOM
CONTROLLER'S DIVISION
A
PURCHASE REQUISITION
By Requisition No.
PURCHASE ORDER
C
B
To Vendor
D
By Purchase Order
By Vendor
RECEIVING REPORT
From Vendor
INVOICE
E
F
VOUCHER WITH DOCUMENTS
G
EXPLANATORY NOTES
A = PREPARE PURCHASE REQUISITION (3 Copies) AS NEEDED
B = PREPARE PURCHASE ORDER (6 Copies)
C = ATTACH PURCHASE REQUISITION TO PURCHASE ORDER
D = MERCHANDISE RECEIVED, COUNTED, AND RECEIVING REPORT (3 Copies) PREPARED BASED ON COUNT AND PURCHASE ORDER
E = MATCH PURCHASE ORDER, PURCHASE REQUISITION, RECEIVING REPORT AND INVOICE
F = PREPARE VOUCHER AFTER COMPARING DATA ON PURCHASE ORDER, INVOICE, AND RECEIVING REPORT
G = TO CASH DISBURSEMENTS IN CONTROLLER'S DIVISION FOR PAYMENT

Number 7 (Estimated time — 20 to 30 minutes)

The **complete set** of financial statements for The Maumee Corporation for the year ended August 31, 1975, is presented below:

The Maumee Corporation
BALANCE SHEET
(In Thousands of Dollars)
August 31, 1975

Assets

Cash		$ 103
Marketable securities, at cost which approximates market value		54
Trade accounts receivable (net of $65,000 allowance for doubtful accounts)		917
Inventories, at cost		775
Property, plant and equipment	$3,200	
Less: Accumulated depreciation	1,475	1,725
Prepayments and other assets		125
Total assets		$3,699

Liabilities and Stockholders' Equity

Accounts payable	$ 221
Accrued taxes	62
Bank loans and long-term debt	1,580
Total liabilities	1,863
Capital stock, $10 par value (authorized 50,000 shares, issued and outstanding 42,400 shares)	424
Paid-in capital in excess of par value	366
Retained earnings	1,046
Total stockholders' equity	1,836
Total liabilities and stockholders' equity	$3,699

The Maumee Corporation
STATEMENT OF INCOME AND RETAINED EARNINGS
(In Thousands of Dollars)
For the Year Ended August 31, 1975

Product sales (net of $850,000 sales returns and allowances)		$10,700
Cost of goods sold		8,700
Gross profit on sales		2,000
Operating expenses:		
Selling expenses	$1,500	
General and administrative expenses	940	2,440
Operating loss		(440)
Interest expense		150
Net loss		(590)
Retained earnings, September 1, 1974		1,700
		1,110
Dividends:		
Cash — $1 per share	40	
Stock — 6% of shares outstanding	24	64
Retained earnings, August 31, 1975		$ 1,046

Required:

List deficiencies and omissions in The Maumee Corporation's financial statements and discuss the probable effect of the deficiency or omission on the auditor's report. Assume that The Maumee Corporation is unwilling to change the financial statements or make additional disclosures therein.

Consider each deficiency or omission separately, and do **not** consider the cumulative effect of the deficiencies and omissions on the auditor's report. There are **no** arithmetical errors in the statements.

Organize your answer sheet in two columns as indicated below and write your answer in the order of appearance within the general headings of Balance Sheet, Statement of Income and Retained Earnings, and Other.

Financial Statement Deficiency or Omission	*Discussion of Effect on Auditor's Report*

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN BUSINESS LAW

(Commercial Law)

November 7, 1975; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	25	30
No. 2	25	30
No. 3	25	30
No. 4	20	25
No. 5	35	40
No. 6	20	25
No. 7	25	30
Total for examination	175	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered from 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The text of a letter from Bridge Builders, Inc., to Allied Steel Co. follows:

> We offer to purchase 10,000 tons of No. 4 steel pipe at today's quoted price for delivery two months from today. Your acceptance must be received in five days.

What type of contract did Bridge Builders intend to create?

a. Express.
b. Unilateral.
c. Bilateral.
d. Joint.

Answer Sheet

99. a. :::::::::: b. :::::::::: c. ████ d. ::::::::::

Items to be Answered

1. With respect to a contract for the sale of goods, a definite and seasonable expression of acceptance sent within a reasonable time is effective as an acceptance even though it states minor additional terms to those offered, except in which of the following situations?
   a. The acceptance was accompanied by a request that the goods be shipped by truck instead of by rail, if convenient.
   b. The offer impliedly limits acceptance to its terms.
   c. Acceptance is expressly conditional on assent to the additional terms.
   d. The price is in excess of $500.

2. In a contract for the sale of goods, express warranties by the seller are created by any
   a. Reasonable implication based upon the seller's acts.
   b. Description of the goods which is made part of the basis of the contract.
   c. Expression of the value of the goods.
   d. Statement of seller's opinion.

3. An oral contract for the sale of goods for a price in excess of $500 is enforceable by the seller if
   a. The goods are generally suitable for sale to others in the ordinary course of the seller's business.
   b. The buyer admits in court that the contract was made.
   c. Payment has **not** yet been made by the buyer.
   d. The goods have been received but **not** accepted by the buyer.

4. Banner Company has entered an agreement to buy its actual annual requirements of certain goods from Shannon Company. The agreement between Banner and Shannon
   a. Is **not** enforceable because it is too indefinite.
   b. Lacks mutuality of obligation.
   c. Is enforceable.
   d. Must state a quantity term fixed by a good faith estimate.

5. Sills Corporation of 123 Main Street entered into a contract to sell goods to Baskins of 456 Atlantic Avenue in the same town as Sills. The parties reached an agreement with respect to price and quantity but failed to state the place of delivery.
   a. The place of delivery is the seller's place of business.
   b. The place of delivery is the buyer's place of business.
   c. The contract is unenforceable because of indefiniteness.
   d. The place of delivery is that which is reasonable under the circumstances.

6. Suggs Company agreed to sell certain goods to Barr Corporation pursuant to a written contract. **No** shipment or delivery date was specified in the contract. Based on these facts
   a. The time for shipment is within a reasonable time.
   b. The time for shipment must be agreed upon.
   c. The time for shipment is within 3 months.
   d. The contract fails for indefiniteness.

7. Unless specifically excluded, a contract for the sale of goods includes a warranty of
   a. Good title.
   b. Fairness.
   c. Usefulness.
   d. Adequate consideration.

8. A merchant's offer to sell goods which states that the offer will be held open is revocable during the time stated
   a. In all situations.
   b. Unless the offer is evidenced by a signed writing.
   c. Unless the offer is oral and has a duration of 6 months or less.
   d. Only if the goods are fungible.

9. Which of the following statements **best** describes a composition agreement unanimously agreed to by all creditors?
   a. It provides for the appointment of a receiver to take over and operate the debtor's business.
   b. It is subject to approval by a federal district court judge.
   c. It provides for a discharge of the debts included in the composition agreement upon performance by the debtor.
   d. It binds only those creditors who do **not** subsequently withdraw from the agreement prior to its consummation.

10. Dexter had assets of $80,000 and liabilities of $100,000, all unsecured. He owed $25,000 to each of the following: Petrie, Dey, Mabley, and Norris. Petrie, Dey, and Mabley agreed with each other and with Dexter to accept 70 cents on the dollar in immediate satisfaction of their debts. Under these circumstances
   a. The agreement is void for lack of consideration.
   b. The agreement would **not** constitute an act of bankruptcy.
   c. Norris would be bound by the agreement.
   d. The agreement described is an assignment for the benefit of creditors.

11. Ted Dolson has filed a voluntary petition in bankruptcy. His assets are listed as $4,200 and his liabilities $18,750. His creditors include (1) three employees who have **not** been paid wages for six weeks at $100 per week per employee, (2) the United States government for $6,900 in back income and social security taxes, (3) his former wife for back alimony payments of $3,000, and (4) suppliers for goods purchased on open account for $7,050. In this situation
   a. All the debts in question are dischargeable in bankruptcy.
   b. Claims must be filed within three months of the filing of the petition in bankruptcy.
   c. The wage earners have the first priority after administration costs.
   d. The United States government claim will take precedence over the security interests of secured creditors.

12. Sims became an agent for Paul with the power to sell goods furnished by Paul but with the requirement that Sims would guarantee payment to Paul for all credit sales made by Sims. Under the circumstances
   a. Sims is an agent coupled with an interest.
   b. The Statute of Frauds applies to the above arrangement regardless of the amount of sales Sims makes.
   c. Sims is a surety vis-a-vis any credit sales he makes on Paul's behalf.
   d. The relationship between Sims and Paul is subject to the Federal Fair Labor Standards Act.

Items 13 and 14 are based upon the following information:

A petition in bankruptcy was filed against Burt on July 1, 1975. Burt was insolvent during 1975 and owed a large amount of money to various creditors, including Charles. Charles has furnished assorted merchandise to Burt on credit. On February 1, 1975, Burt paid $3,000 to Charles on account with an intent to prefer him over other creditors. On April 1, 1975, Burt paid Charles an additional $2,000 with the same intent. On May 1, 1975, Charles sold goods to Burt, for cash, at the normal price of $1,400; this was his only other transaction with Burt in 1975. On all occasions, Charles had **no** basis upon which to believe that Burt was bankrupt.

13. In this situation
   a. Neither the February 1 nor the April 1 transfers constituted an act of bankruptcy.
   b. Both the February 1 and the April 1 transfers constituted acts of bankruptcy.
   c. The May 1 sale of goods to Burt is neither an act of bankruptcy nor a voidable preference.
   d. Both the February 1 and the April 1 transfers may be voided by the trustee in bankruptcy.

14. If Charles received his payments with actual knowledge of Burt's insolvency in the bankruptcy sense, the amount which the trustee may recover is
   a. $6,400.
   b. $5,000.
   c. $2,000.
   d. $1,400.

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15. Farley Farms, Inc., shipped 100 bales of hops to Burton Brewing Corporation. The agreement specified that the hops were to be of a certain grade. Upon examining the hops, Burton claimed that they were **not** of that grade. Farley's general sales agent who made the sale to Burton agreed to relieve Burton of liability and to have the hops shipped elsewhere. This was done, and the hops were sold at a price less than Burton was to have paid. Farley refused to accede to the agent's acts and sued Burton for the amount of its loss. Under these circumstances
   a. Farley will prevail only if the action by its agent was expressly authorized.
   b. Even if Farley's agent had authority to make such an adjustment, it would **not** be enforceable against Farley unless ratified in writing by Farley.
   c. Because the hops were sold at a loss in respect to the price Burton had agreed to pay, Burton would be liable for the loss involved.
   d. Farley is bound because its agent expressly, impliedly, or apparently had the authority to make such an adjustment.

16. The ratification doctrine with respect to principal and agent
    a. Does **not** apply to real estate contracts.
    b. Requires that a written notice of ratification be sent to the third party and the agent in order to create an enforceable contract.
    c. Does **not** apply to torts committed by the agent.
    d. Requires that the agent or purported agent indicates to the third party that he is acting for and on behalf of the person subsequently ratifying.

Number 2 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

17. Jackson Enterprises dismissed its auditors for cause. The CPA firm failed to complete its audit within the time stipulated due to its own inefficiency. Under the circumstances
    a. The client has the right to all of the CPA's working papers relating to the engagement which are retained by the CPA.
    b. The CPA firm is entitled to recover the full fee agreed upon less a per diem diminution of 5% for each day delayed.
    c. Recovery by the CPA firm in quasi contract will **not** be available if as a result of the delay the audit is worthless to Jackson.
    d. If Jackson sues the CPA firm for damages for breach of contract, recovery will be denied because it is commonly recognized that unless the contract so stipulates, time is **not** of the essence.

18. The traditional common-law rules regarding accountants' liability to third parties for negligence
    a. Remain substantially unchanged since their inception.
    b. Were more stringent than the rules currently applicable.
    c. Are of relatively minor importance to the accountant.
    d. Have been substantially changed at both the federal and state levels.

19. A third-party purchaser of securities has brought suit based upon the Securities Act of 1933 against a CPA firm. The CPA firm will prevail in the suit brought by the third party even though the CPA firm issued an unqualified opinion on materially incorrect financial statements if
    a. The CPA firm was unaware of the defects.
    b. The third-party plaintiff had **no** direct dealings with the CPA firm.
    c. The CPA firm can show that the third-party plaintiff did **not** rely upon the audited financial statements.
    d. The CPA firm can establish that it was **not** guilty of actual fraud.

20. Henry Lamb worked for several years for a major CPA firm which has offices in 37 states. He resigned his position with the CPA firm, then returned to his home state where he opened his own CPA practice. Under the circumstances
    a. Lamb will be liable for damages to his former employer if he engages in the practice of accounting in any state in which the firm has offices.
    b. Lamb will be liable for damages to his former employer if he accepts as his client any party, solicited or unsolicited, who had been a client of his former employer immediately prior to his being retained by said client.
    c. He must obtain permission of the state board of accountancy in the state in which he was previously employed in order to relocate.
    d. He must be licensed to practice as a CPA in his home state.

21. Martinson is a duly licensed CPA. One of his clients is suing him for negligence alleging that he failed to meet generally accepted auditing standards in the current year's audit thereby failing to discover large thefts of inventory. Under the circumstances
    a. Martinson is **not** bound by generally accepted auditing standards unless he is a member of the AICPA.
    b. Martinson's failure to meet generally accepted auditing standards would result in liability.
    c. Generally accepted auditing standards do **not** currently cover the procedures which must be used in verifying inventory for balance-sheet purposes.
    d. If Martinson failed to meet generally accepted auditing standards, he would undoubtedly be found to have committed the tort of fraud.

22. Surplus of a corporation means
    a. Net assets in excess of stated capital.
    b. Liquid assets in excess of current needs.
    c. Total assets in excess of total liabilities.
    d. Contributed capital.

23. Walters & Whitlow, CPAs, failed to discover a fraudulent scheme used by Davis Corporation's head cashier to embezzle corporate funds during the past five years. Walters & Whitlow would have discovered the embezzlements promptly if they had **not** been negligent in their annual audits. Under the circumstances, Walters & Whitlow will normally **not** be liable for
   a. Punitive damages.
   b. The fees charged for the years in question.
   c. Losses occurring after the time the fraudulent scheme should have been detected.
   d. Losses occurring prior to the time the fraudulent scheme should have been detected and which could have been recovered had it been so detected.

24. Authorized shares means the shares of all classes of stock which a corporation
   a. Has legally outstanding.
   b. Is legally permitted to issue.
   c. Has issued including treasury shares.
   d. Has issued excluding treasury shares.

25. Treasury shares of a corporation are its shares which are
   a. Issued and outstanding.
   b. Issued but **not** outstanding.
   c. Outstanding but **not** issued.
   d. Neither outstanding nor issued.

26. For legal purposes, net assets of a corporation means the amount
   a. By which current assets exceed its current liabilities.
   b. By which liquid assets exceed its current liabilities.
   c. By which total assets exceed its total liabilities.
   d. Of its current assets.

27. Capital surplus of a corporation means
   a. The portion of its entire surplus other than earned surplus.
   b. Contributed capital.
   c. Working capital.
   d. Stated capital.

28. Mr. Parker has been issued 100 shares of common stock of Capital, Inc., having a par value of $30 per share. What aggregate consideration must Mr. Parker pay for the shares of stock if he is to escape any contingent liability in connection with these shares in the future?
   a. At least $30.
   b. At least $3,000.
   c. Less than $3,000.
   d. Between $30 and $3,000.

29. Caskill Corporation issued 100 shares of its $10 par value common stock to Mr. Jason, its vice-president, for a price of $1,000. In consideration he paid $200 cash, gave a note for $400, cancelled $300 salary owed him for services rendered to the corporation, and promised to render $100 worth of future services. His shares are
   a. Paid in full.
   b. 50% paid for.
   c. 90% paid for.
   d. 20% paid for.

30. Miller Corporation declared a common stock dividend of 1 common share for every 10 common shares outstanding. The owners' equity accounts of the corporation immediately prior to the declaration of the common stock dividend were as follows:

Stated capital (10,000 shares of common stock issued and outstanding, $1 par value per share)	$10,000
Earned surplus (retained earnings)	4,000

No other transactions are relevant. Immediately after the issuance of the common stock dividend, stated capital will amount to
   a. $11,000.
   b. $10,000.
   c. $9,000.
   d. $1,000.

31. Laser Corporation lent $5,000 to Mr. Jackson, a member of its board of directors. Mr. Jackson was also vice-president of operations. The board of directors, but **not** the stockholders, of Laser authorized the loan on the basis that the loan would benefit the Corporation. The loan made to Mr. Jackson is
   a. Proper.
   b. Improper because Mr. Jackson is an employee.
   c. Improper because Mr. Jackson is a director.
   d. Improper because Mr. Jackson is both a director and an employee.

32. The good-faith purchaser of a stolen stock certificate will defeat the claims of the prior owner(s)
   a. Even though the certificate bears the forged indorsement of the prior owner.
   b. Provided the certificate was indorsed in blank by the prior owner.
   c. If the certificate contains **no** indorsement whatsoever.
   d. If the certificate contains the full indorsement of one of the two prior joint owners.

Number 3 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

33. Maxim Corporation, a wholesaler, was indebted to the Wilson Manufacturing Corporation in the amount of $50,000 arising out of the sale of goods delivered to Maxim on credit. Wilson and Maxim signed a security agreement creating a security interest in certain collateral of Maxim. The collateral was described in the security agreement as "the inventory of Maxim Corporation, presently existing and thereafter acquired." In general, this description of the collateral

a. Applies only to inventory sold by Wilson to Maxim.
b. Is sufficient to cover all inventory.
c. Is insufficient because it attempts to cover after-acquired inventory.
d. Must be more specific for the security interest to be perfected against subsequent creditors.

34. In the case of consumer goods, a buyer from the original purchaser takes the goods free of a perfected security interest if

a. He buys without knowledge of the security interest, for value, for his own personal purposes, and the secured party has **not** filed a financing statement covering such goods.
b. He buys without knowledge of the security interest, for value, for his own personal purposes, and prior to the purchase the secured party has filed a financing statement covering such goods.
c. He buys with knowledge of the security interest, and after the purchase the secured party files a financing statement covering such goods.
d. He buys with knowledge of the security interest, and the secured party has **not** filed a financing statement covering such goods prior to delivery of the goods.

35. The scope of secured transactions in the Uniform Commercial Code does **not** include

a. Pledges.
b. Transactions where title has **not** passed.
c. After-acquired collateral.
d. Sale of corporate debentures.

36. On June 10, Central Corporation sold goods to Bowie Corporation for $5,000. Bowie signed a financing statement containing the names and addresses of the parties and describing the collateral. Central filed the financing statement on June 21, noting the same in its accounting books.

a. Central need **not** sign the financing statement to perfect its security interest in the collateral.
b. Central must file the financing statement prior to the sale if a security interest is to be perfected.
c. Central must sign the financing statement in order to perfect its security interest.
d. Central had a perfected security interest in the collateral even before the financing statement was filed.

37. Article 9 (secured transactions) of the Uniform Commercial Code

a. Does **not** apply if the secured transaction involves personal property which has a value of less than $500.
b. Has been adopted by the Congress of the United States and thus is the law of all the states.
c. Only codified most of the majority rules existing at common law or contained in widely adopted state statutes applicable to secured transactions.
d. Does **not** apply to purchase-money real estate mortgages.

38. Margo, Inc., insured its property against fire with two separate insurance companies, Excelsior and Wilberforce. Each carrier insured the property for its full value, and neither insurer was aware that the other had also insured the property. The policies were the standard fire insurance policies used throughout the United States. If the property is totally destroyed by fire, how much will Margo recover?

a. Nothing because Margo has engaged in an illegal gambling venture.
b. The full amount from both insurers.
c. A ratable or pro rata share from each insurer, **not** to exceed the value of the property insured.
d. Only 80% of the value of the property from each insurer because of the standard co-insurance clause.

39. Your client, Ace Auto Sales, sold a 1974 Skylark Magnificent to Marcus on the installment basis. Marcus signed an installment agreement for the balance due ($2,000) on the purchase price. Ace's policy was **not** to file a financing statement in the appropriate recordation office. Marcus subsequently sold the car to Franks without disclosing the debt owed to Ace. Franks purchased the car in good faith, knowing nothing about the debt owed by Marcus to Ace. Marcus is bankrupt. Wallace, a general creditor of Marcus has asserted rights to the car in question. Under the circumstances

   a. Marcus takes title free and clear of any claims because Ace did **not** file.
   b. Ace can defeat the claim of Franks in that Franks is a mere third party beneficiary.
   c. Ace's rights against Marcus under the contract of sale are unimpaired despite the lack of filing.
   d. In the final analysis Wallace will prevail.

40. Which of the following statements **best** describes the insurable interest requirement?

   a. It is an historical anachronism and has little or **no** validity in modern times.
   b. It is identical for life and property insurance.
   c. It has been abolished by most modern insurance legislation in respect to fire insurance.
   d. At a minimum, it must exist at the time of the loss in respect to property insurance.

41. Snowmobile sales by manufacturers in a relevant market amount to about $10,000,000 annually. Sleekat, a manufacturer who sells its snowmobiles directly to dealers, has sales of about $4,000,000 annually in that market of which about $2,000,000 are to Sport Store. Sport Store has about 40% of the retail market and half of its sales are Sleekat vehicles. Four other manufacturers account for the other 60% of wholesale sales and three other dealers account for the other 60% of retail sales. Under these circumstances

   a. Sleekat would probably commit an antitrust violation by acquiring all of the stock of Sport Store.
   b. Sleekat would probably **not** commit an antitrust violation if it required Sport Store to limit its sales of Sleekat vehicles to persons resident in the defined market and provided that the dealership would be terminated for violation.
   c. Sleekat could require Sport Store to sell only Sleekat vehicles and **no** competing vehicles and probably **not** violate the antitrust laws.
   d. Sleekat could avoid any possible violation of the antitrust laws by acquiring the assets of Sport Store.

42. Boswell Woolen Yarns, Inc., is one of your audit clients. It has been a member of the Woolen Yarns Manufacturers Association of America which has represented 75% of the woolen yarn manufacturers of America for the past ten years. Until recently, the association has served primarily as a public relations and lobbying agent for its members. Now, as a result of severe inflation and competition from manufacturers of other types of fabrics, e.g., super nylon, orlon, etc., it has been proposed by the association and the overwhelming majority of its members that the association provides its members with suggested minimum and maximum prices to be charged and maximum production levels for each member. If the plan is implemented

   a. The association and its members, including your client, have engaged in an illegal contract, combination, or conspiracy in restraint of trade.
   b. There are **no** antitrust implications regarding such an arrangement as long as the parties are **not** compelled to join in the plan.
   c. And the association is appointed by its members as their agent to engage in such activities, the arrangement will **not** be considered a violation of the antitrust laws even if its members could **not** have done so themselves.
   d. Meeting competition from other non-wool manufacturers is a complete defense against any alleged antitrust violations.

43. Inns Corporation operated a major hotel in a metropolitan city. An annual festival week brought many tourists to the city resulting in peak demand for accommodations. The local Tourism Bureau, of which Inns was an active member, embarked on a campaign to increase tourist trade in the area and asked all suppliers of goods to hotels and restaurants to contribute 1% of sales revenue to the bureau. Bureau members also were of the opinion that higher prices could be charged during the festival week without hurting the tourist trade. Which of the following actions would most likely violate the antitrust laws?

   a. Rental of Inns' main ballroom on the key day of the festival at a price below that offered by other hotels.
   b. The raising of rates on hotel rooms during festival week when other hotels also raise their rates.
   c. Inns' notification to its purchasing officer to confine its purchases to suppliers contributing to the Tourism Bureau as agreed with other bureau members.
   d. Inns' policy of purchasing soap products from only one manufacturer even though there were offers of lower prices for similar goods from other manufacturers.

44. The federal Social Security Act
   a. Does **not** apply to self-employed businessmen.
   b. Excludes professionals such as accountants, lawyers, and doctors.
   c. Provides for a deduction by the employee which is available against his federal income tax.
   d. Provides that bonuses and commissions paid as compensation are included as wages in the calculation of employer-employee contributions.

45. One of your CPA firm's clients, Destination Garages, Inc., has entered into an agreement with its principal competitor, Parking Unlimited, Inc., to eliminate cut-throat competition. They have agreed to charge a uniform hourly rate in the different areas in which they compete. The garages are mainly located in Metropolis, but some are located in another state which is just across the state line from Metropolis. It is agreed that the rates to be charged are (1) **always** to be reasonable and (2) to be based upon the rate structure charged by the leading parking lot operator in Central City, the capital of the state in which Metropolis is located. What is the status of the agreement between Destination Garages and Parking Unlimited in regard to federal antitrust law?
   a. Because the garages are real property, antitrust law does **not** apply.
   b. Because the "product" sold is a service, antitrust law does **not** apply.
   c. Regardless of the fact that the prices agreed upon are aimed at avoiding cut-throat competition, are always to be reasonable to the public, and are based upon another company's rates, the prices agreed upon are, nevertheless, in violation of the antitrust law.
   d. If Destination Garages can show that it was in fact merely meeting competition from other parking lots, it would have a complete defense against any alleged antitrust violation.

46. Marvel Toys, Inc., manufactures and sells toys to Gem Stores, a large department store chain, and to Fantastic Discounts, a major toy retailer, at prices below its sales price of similar toys to other retailers in the market area. Its pricing policy vis-a-vis Gem is based solely upon the fact that Gem is a new customer and the low prices were quoted in order to obtain its business and thereby eliminate Marvel's unused production capacity. For Fantastic, the lower prices are charged in order to meet the identical prices legally charged by a competitor. In assessing the potential violation of antitrust laws against price discrimination, it would appear that Marvel Toys
   a. Has **not** violated the antitrust laws as long as none of its competitors can show damages.
   b. Has a valid defense with respect to its sales to Gem.
   c. Has **not** violated the antitrust laws with respect to its sales to Fantastic.
   d. Will **not** have committed any violation if it was operating at a loss at the time of the sales.

47. Paperbox Company is one of four equal-sized paper-carton container companies whose sales constitute 90% of paper container sales in the relevant market. Competition has been intense. In order to control costs within reasonable limits the chief executive officers of the four companies have agreed that they will set a maximum price, agreed upon by them, to be paid for the pulp they purchase. From an antitrust standpoint
   a. **No** antitrust violation occurs if the price set is reasonable.
   b. The agreement is a *per se* violation of the antitrust laws.
   c. **No** antitrust violation occurs if the suppliers of raw pulp agree that the price is reasonable and works in the best interest of all parties.
   d. The agreement will **not** violate the antitrust laws if it can be shown that it is necessary to prevent insolvency of one of the parties to the agreement who controls 30% of the market.

48. Workmen's compensation laws are
   a. Governed by federal regulation.
   b. Applicable to all types of employment.
   c. Designed to eliminate the employer's defense of contributory negligence when an employee is injured on the job.
   d. **Not** applicable if the employee signs a waiver and consents to his noncoverage under workmen's compensation at the time he is hired.

Number 4 (Estimated time — 20 to 25 minutes)

Part a. On June 1, 1975, Markum Realty, Inc., offered to sell one acre of land in an industrial park it owned to Johnson Enterprises, Inc. The offer was by mail and, in addition to the other usual terms, stated: "This offer will expire on July 2, 1975, unless acceptance is received by the offeror on or before said date."

Johnson decided to purchase the tract of land and on July 1, telegraphed its acceptance to Markum. The acceptance telegram was delayed due to the negligence of the telegraph company which had admitted that delivery was not made to Markum until July 3. Markum decided not to sell to Johnson because it had received a better offer, but it remained silent and did not notify Johnson of its decision.

When Johnson did not hear from Markum by July 11, its president called the president of Markum and inquired when Johnson might expect to receive the formalized copy of the contract the two companies had entered into. Markum's president responded that there was no contract.

Required:

1. Did a contract result from the above described dealings between Markum and Johnson? Discuss the legal implications of **each** communication between the parties in your explanation.

2. Assuming a contract did not arise, does Johnson have any legal recourse against the telegraph company? Explain.

Part b. Your client, Donaldson Manufacturing, Inc., a family owned corporation, approached the Faber Corporation to purchase raw materials on a credit basis of 2/10, net/60. Faber Corporation insisted that John Donaldson, Donaldson Manufacturing's president and principal stockholder, guarantee payment of the corporation's debt. John Donaldson did so. After 8 months of prompt payments within the 60 days, Donaldson Manufacturing was unable to make payment within 60 days. Consequently, Faber refused to make further deliveries, demanded immediate payment plus interest, and threatened to sue Donaldson Manufacturing and John Donaldson on the debt. Shortly thereafter, Donaldson Manufacturing tendered full payment in cash to Faber. Faber refused to accept the cash because it was after banking hours.

Required:

1. What are the legal implications resulting from Faber's actions in respect to John Donaldson's personal liability? Explain.
2. What are the legal implications to Donaldson Manufacturing as a result of Faber's refusal to accept the tender of payment? Explain.

Part c. Fox Construction Corporation obtained a $20 million contract from the United States government to construct a federal office building. The contract required Fox to obtain a surety (or sureties) guaranteeing performance of the contract. After contacting several surety companies, Fox learned that no one company would write a bond for that amount. However, Fox was able to obtain a $10 million bond from Ace Surety Company and a $5 million bond each from Empire Surety and the Excelsior Surety Company. Fox breached the contract and, as a result, the United States government suffered a $2 million loss.

Required:

1. What are the rights of the United States against the three surety companies? Explain.
2. When finally settled, for what amount will each surety company be liable? Explain.

Number 5 (Estimated time –– 35 to 40 minutes)

Part a. Boswell Realty Corporation, whose sole business is land development, purchased a large tract of land on which it intended to construct a high-rise apartment-house complex. In order to finance the construction, Boswell offered to sell $3,000,000 worth of shares in Boswell Realty to about 1,000 prospective investors located throughout the United States.

Required:

1. Discuss the implications of the Securities Act of 1933 to Boswell's offering to sell shares in the corporation.
2. The Securities Act of 1933 is considered a disclosure statute. Briefly describe the means provided and the principal types of information required to accomplish this objective of disclosure.
3. If an investor acquires shares of stock in Boswell Realty Corporation, is his interest real or personal property? Explain.

Part b. Taylor Corporation, incorporated and doing business in Delaware, is a manufacturing company whose securities are registered on a national securities exchange. On February 6, 1975, one of Taylor's engineers disclosed to management that he had discovered a new product which he believed would be quite profitable to the corporation. Messrs. Jackson and Wilson, the corporation's president and treasurer and members of its board of directors, were very impressed with the prospects of the new product's profitability. Because the corporation would need additional capital to finance the development, production, and marketing of the new product, the board of directors proposed that the corporation issue an additional 100,000 shares of common stock.

Wilson was imbued with such confidence in the corporation's prospects that on February 12, 1975, he purchased on the open market 1,000 shares of the corporation's common stock at $10 per share. This was before news of the new product reached the public in late February and caused a rise in the market price to $30 per share. Jackson did not purchase any shares in February because he had already purchased 600 shares of the corporation's common stock on January 15, 1975, for $10 per share.

In late February, when the market price of the corporation's common stock was $30 per share, Wilson approached two insurance companies to discuss the proposed issuance of an additional 100,000 shares of common stock. In March, Wilson reported to the board of directors that negotiations had been successful and one of the insurance companies had agreed to purchase the entire 100,000 shares for $3,000,000. The insurance company signed an investment letter, and a legend restricting transfers was imprinted on the face of each certificate issued to it. Moreover, the appropriate stop-transfer instructions were given to the corporation's stock-transfer agent.

Due to unexpected expenses arising from a fire in his home, on April 16, 1975, Jackson sold at $35 per share on the open market the 600 shares of stock he purchased in January. Wilson continues to hold his 1,000 shares.

Required:

What questions arising out of the federal securities laws are suggested by these facts? Discuss.

Number 6 (Estimated time — 20 to 25 minutes)

Part a. Harry Fisk operates a local tuna cannery. On May 31, 1975, your client, Fair Food Wholesalers, Inc., purchased 100 cases of tuna for $12 per case, FOB Fisk's warehouse. The contract expressly stipulated that the tuna was to be first quality and all white meat in "solid chunks." It was further agreed that Fair Food had until June 10, 1975, to inspect the tuna before the transaction became final. Consequently, on May 31, 1975, Fair Food gave Fisk the following instrument:

> No. 1625
>
> FAIR FOOD WHOLESALERS, INC.
>
> 1-12/210
>
> *June 10, 1975*
>
> Pay to the order of *Bearer* *$1,200.00*
>
> *Twelve hundred & no/100's* Dollars
>
> Fair Food Wholesalers, Inc.
>
> By *James Duff, President*
>
> CENTURY BANK
> 2 Broadlane
> Providence, R.I.
>
> *For tuna purchase from Harry Fisk per contract dated May 31, 1975*

Fisk had orally agreed not to transfer the above instrument until June 10 or at the time final acceptance was manifested by Fair Food if this was earlier.

Fisk disregarded this agreement and promptly transferred the instrument to one of his creditors, Ross, who was threatening to force Fisk into bankruptcy. Ross took the instrument in good faith and without notice of any claim or defense in satisfaction of indebtedness arising from previous sales to Fisk which were overdue. The instrument was not indorsed by Fisk.

On June 10, 1975, Fair Food sample tested the tuna and found that it was not first quality and that it was not all white meat in solid chunks. Fair Food promptly notified Century Bank to stop payment on the instrument. Century did so and Ross is seeking recovery against Fair Food. In addition, Fair Food notified Fisk that it rejected the shipment and that it was holding the tuna on Fisk's behalf awaiting instructions from Fisk for disposition.

Required:

What are Ross's rights, if any, against Fair Food and Century Bank on the instrument? Explain.

Part b. On September 30, 1975, Dayton Blasting Company purchased 25 cases of blasting caps from Whitten Blasting Cap Company. In this connection, it gave Whitten the following instrument:

> September 30, 1975
>
> Dayton Blasting Company hereby promises to pay Whitten Blasting Cap Company Six Hundred Fifty Dollars ($650.00) on December 1, 1975, plus interest at 6% per annum from date.
>
> Dayton Blasting Company
>
> By Malcolm Smalley
> MALCOLM SMALLEY, President

Whitten promptly transferred the above instrument to Vincent Luck for $600. James Whitten, president of Whitten, indorsed the instrument on the back as follows: "Pay to the order of Vincent Luck" signed Whitten Blasting Cap Company per James Whitten, President.

Approximately half of the blasting caps were defective and Dayton refused to pay on the instrument. Dayton returned the defective cases and used the balance.

Required:

What are Vincent Luck's rights on the instrument in question? Explain.

Number 7 (Estimated time — — 25 to 30 minutes)

Number 7 consists of two parts, and the following information applies to both parts.

Your client, Williams, Watkins, and Glenn, is a general partnership engaged primarily in the real estate brokerage business; however, in addition, it buys and sells real property for its own account. Williams and Watkins are almost exclusively responsible for the brokerage part of the business, and Glenn devotes almost all of his time to partnership acquisitions and sales of real estate. The firm letterhead makes no distinction along these functional lines and all members are listed as licensed real-estate brokers. Normally acquisitions are made in the firm name; although for convenience or other reasons, Glenn occasionally takes title in his own name for and on behalf of the firm.

The partnership agreement contains, among other provisions, the following:

- No partner shall reduce the standard real estate commission charged (6%) without the consent of at least one other partner.
- No partner shall purchase or sell real property for or on behalf of the partnership without the consent of all other partners. Title to real property so acquired shall be taken exclusively in the partnership name, unless otherwise agreed to by all the partners.
- All checks received which are payable to the partnership and all checks and cash received for or on behalf of the partnership shall be deposited intact in one of the partnership's bank accounts.

Part a. Watkins showed a magnificent $350,000 ranch estate, listed for over a year with the firm by John Foster, to numerous prospective purchasers. The firm's exclusive listing had recently expired and Watkins was afraid the firm would lose the sale. Foster's price was firm, and he had repeatedly refused to negotiate with interested parties or accept an offer below $350,000. The most recent prospective buyer offered $340,000 but would not budge from that price. Watkins, fearing that a rival broker might obtain a buyer and cause him to lose the commission, agreed to lower the commission to $11,000 which was acceptable to Foster. Watkins did this without the consent of either of the other partners.

Required:

1. Can Williams, Watkins, and Glenn or Williams and Glenn recover from Foster the $10,000 reduction in the commission granted by Watkins to Foster? Explain.
2. What recourse does the partnership or the other partners have against Watkins? Explain.

Part b. During your firm's annual examination of the financial statements of Williams, Watkins, and Glenn, the staff auditor discovered that Glenn had recently engaged in a series of questionable transactions affecting the firm's financial position. Following is a description of these transactions.

First, Glenn sold a tract of land to Bill Sparks for $18,500. Title to the land was held in the name of the partnership. Spark's check was payable to the partnership and was cashed by Glenn at the First City Bank which handled the firm's checking account. Glenn indorsed the firm name "Per Donald Glenn, Partner" and took the cash. Obtaining this amount of cash at the First City Bank was not an uncommon practice for the partnership because the firm paid its substantial weekly payroll and commissions in cash.

Glenn's second series of transactions involved the sale of the firm's former office building for $38,000 to Charles Whitmore. Whitmore was formerly associated with the firm but had left to establish his own real-estate business and was currently a tenant in the firm's old offices. Whitmore was cognizant of the express limitations on the partners' authority contained in the Williams, Watkins, and Glenn partnership agreement. However, Whitmore was assured by Glenn that the requisite consent for his individual actions had been obtained from the other partners regarding the sale in question. Glenn also persuaded Whitmore, "for convenience sake," to make the check payable to his individual order. Glenn cashed the check at one of the savings banks in which the firm had a balance in excess of $50,000.

Glenn's third series of transactions began when he acquired a tract of land for $55,000 from Arthur Douglas. Glenn paid for the land with a partnership check but took record title in his own name. A few days later, two days before leaving for vacation, Glenn closed the sale of this property to Frank Carlson and received a certified check for $58,500 payable to his own order. The proceeds of this sale were not deposited in any of the firm's bank accounts. Glenn has not returned from his vacation. In fact, he is five days overdue and has not communicated with the firm. It was subsequently learned that he cashed the check and retained the funds for his personal use.

Required:

1. What rights does the partnership or Williams and Watkins have against Bill Sparks or First City Bank? Explain.
2. What rights does the partnership or Williams and Watkins have against Charles Whitmore? Explain.
3. What rights does the partnership or Williams and Watkins have against Frank Carlson? Explain.
4. What rights does the partnership or Williams and Watkins have against Glenn?

(Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, territories, and the District of Columbia.)

EXAMINATION IN ACCOUNTING THEORY

(Theory of Accounts)

November 7, 1975; 1:30 to 5:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	*Estimated Minutes* *Minimum*	*Maximum*
No. 1	25	30
No. 2	25	30
No. 3	25	30
No. 4	25	30
No. 5	25	30
No. 6	25	30
No. 7	25	30
Total for examination	175	210

INSTRUCTIONS TO CANDIDATES

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers they should be numbered 1 through 12.

   The printed answer sheet provided for the objective-type items should be considered to be Page 1.

2. A CPA is continually confronted with the necessity of expressing his opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language will be considered by the examiners.

DISREGARD OF THESE INSTRUCTIONS MAY BE CONSIDERED AS INDICATING INEFFICIENCY IN ACCOUNTING WORK.

Number 1 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of issues in financial accounting and managerial accounting.** Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The recommended title for the financial statement which summarizes changes in financial position is the statement of
    a. Changes in financial position.
    b. Changes in working capital.
    c. Sources and applications of funds.
    d. Cash flow.

Answer Sheet

99. a. b. :::::::::: c. :::::::::: d. ::::::::::

Items to be Answered

1. When using the periodic-inventory method, which of the following generally would **not** be separately accounted for in the computation of cost of goods sold?
    a. Trade discounts applicable to purchases during the period.
    b. Cash (purchase) discounts taken during the period.
    c. Purchase returns and allowances of merchandise during the period.
    d. Cost of transportation-in for merchandise purchased during the period.

2. When a pension plan is adopted, the past service benefit cost of employees should be charged to
    a. Retained earnings.
    b. Expense only as paid.
    c. Expense in current and future periods.
    d. Expense in the current period only.

3. If a company has a legal obligation for pension cost in excess of amounts paid and amounts accrued, the excess should be shown on the statement of financial position as
    a. Both a liability and a deferred charge.
    b. A liability only.
    c. A deferred charge only.
    d. Neither a liability nor a deferred charge, but the excess should be disclosed in a note to the financial statements.

4. Following the guides set by the Accounting Principles Board, the minimum charge to expense permitted in accounting for pension plan expense is
    a. Normal cost.
    b. Normal cost, plus a prescribed percentage of prior (or past) service cost.
    c. Normal cost, plus interest on unfunded prior (or past) service cost, plus a prescribed percentage of any increase in prior service costs arising from amendments to the plan.
    d. Normal cost, plus interest on unfunded prior (or past) service cost, plus a possible provision for vested benefits.

5. A pension fund actuarial gain or loss that is caused by a plant closing should
    a. Be recognized immediately as a gain or loss.
    b. Be spread over the current year and future years.
    c. Be charged or credited to the current pension expense.
    d. Be recognized as a prior period adjustment.

6. Which of the following actuarial cost methods is **not** an acceptable method for determining pension cost?
    a. Unit credit.
    b. Individual level premium.
    c. Terminal funding.
    d. Entry age normal.

7. Which of the following disclosures of pension-plan information would **not** normally be required by the Accounting Principles Board to be included in the financial statements?
    a. The estimated pension expense for the period.
    b. The amount paid from the pension fund to retirees during the period.
    c. A statement of the company's accounting and funding policies for the pension plan.
    d. The nature and effect of significant pension-plan matters affecting comparability for all periods presented.

8. To what extent is treasury stock assumed to be acquired by a corporation applying the treasury stock method in earnings per share calculations?
    a. To the maximum extent possible.
    b. Up to 20% of earnings for the period being reported on.
    c. None, until all long-term debt has been, in effect, retired; then, to the maximum extent possible.
    d. Up to 20% of outstanding common stock.

9. How should the proceeds from the issuance of debt securities with detachable warrants be accounted for?
    a. As debt only.
    b. As warrants only.
    c. As both debt and warrants.
    d. As either debt or warrants, but **not** as both.

10. Which of the following should a corporation use to measure employee compensation when an option for convertible stock is granted to employees in a compensatory stock option plan?
    a. The quoted market price of the convertible stock.
    b. The quoted market price of the security into which the stock is convertible.
    c. The higher of the quoted market price of the convertible stock or the security into which the stock is convertible.
    d. The lower of the quoted market price of the convertible stock or the security into which the stock is convertible.

11. The September 30, 1975, physical inventory of Clinton Company appropriately included $3,800 of merchandise which was **not** recorded as purchases until October 1975. What effect will this error have on September 30, 1975, assets, liabilities, retained earnings, and earnings for the year then ended, respectively?
    a. **No** effect; overstate; understate; understate.
    b. **No** effect; understate; understate; overstate.
    c. Understate; **no** effect; overstate; overstate.
    d. **No** effect; understate; overstate; overstate.

12. An overstatement of reported earnings may result from the failure to record
    a. Dividends in arrears on preferred stock outstanding.
    b. An accrued liability.
    c. Amortization of premium on bonds payable.
    d. A contingent liability.

13. Which of the following describes the amount at which a parent company should carry its unconsolidated domestic subsidiary on its separate financial statements in periods subsequent to acquisition?
    a. Original cost of the investment to the parent company.
    b. Original cost of the investment adjusted for the parent's share of the subsidiary's earnings, losses, and dividends.
    c. Current market value of the investment adjusted for dividends received.
    d. Current market value of the investment.

14. In a parent's unconsolidated financial statements, which accounts, other than cash, are affected when reflecting a subsidiary's earnings and dividends?
    a. Dividend revenue, equity in earnings of subsidiary, and retained earnings.
    b. Dividend revenue and retained earnings.
    c. Investment in subsidiary, equity in earnings of subsidiary, dividend revenue, and retained earnings.
    d. Investment in subsidiary, equity in earnings of subsidiary, and retained earnings.

15. Which of the following is one of the purposes of standard costs?
    a. To simplify costing procedures and expedite cost reports.
    b. To replace budgets and budgeting.
    c. To use them as a basis for product costing for external-reporting purposes.
    d. To eliminate having to account for underapplied or overapplied factory overhead at the end of the period.

16. Which of the following statements **best** describes a characteristic of a factory-overhead control report prepared for use by a production-line department head?
    a. It is more important that the report be precise than timely.
    b. The report should include information on all costs chargeable to the department, regardless of their origin or control.
    c. The report should be stated in dollars rather than in physical units so the department head knows the financial magnitude of any variances.
    d. The costs in the report should include only those controllable by the department head.

17. Given below are the following notations and their respective meanings:

AH = Actual hours
SHA = Standard hours allowed for actual production
AR = Actual rate
SR = Standard rate

Which formula represents the calculation of the labor-efficiency variance?
    a. SR(AH–SHA).
    b. AR(AH–SHA).
    c. AH(AR–SR).
    d. SHA(AR–SR).

18. The effect of changes in semi-variable costs in relation to another item, such as direct-labor hours, can **best** be determined by which of the following mathematical techniques?
    a. Simplex method.
    b. Matrix algebra.
    c. Correlation analysis.
    d. Probability analysis.

19. The forecast of sales for the next accounting period has been stated as $100,000 by the marketing vice-president of a merchandising company. Which of the following techniques was most likely used by the marketing vice-president in his sales forecast?
    a. Probability analysis.
    b. Linear programming.
    c. Cost-volume-earnings analysis.
    d. Program evaluation review technique (PERT).

20. An advantage of using the payback method of evaluating capital-budgeting alternatives is that payback is
    a. Precise in estimates of profitability.
    b. Easy to apply.
    c. Based on non-cash-flow data.
    d. Insensitive to the life of the project(s) considered.

Number 2 (Estimated time — 25 to 30 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of issues in financial accounting and state and local governmental accounting**. Use a soft pencil, preferably No. 2, to blacken the appropriate space on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on your total correct answers.

Items to be Answered

21. For bonds payable with a term of 20 years, originally issued at a discount and outstanding for 10 years, the theoretically preferred presentation in the statement of financial position is the
    a. Amount expected to be paid to the bondholders at bond maturity date less the present value of interest to be paid in future periods.
    b. Face amount of the bonds less the discount at the date of issue.
    c. Bond maturity value less the unamortized discount when the compound-interest method of amortization is used.
    d. Face amount of the bonds.

22. Kelly Company exchanged inventory items that cost \$8,000 and normally sold for \$12,000 for a new delivery truck with a list price of \$13,000. The delivery truck should be recorded on Kelly's books at
    a. \$8,000.
    b. \$8,667.
    c. \$12,000.
    d. \$13,000.

23. Good Deal Company received \$20,000 in cash and a used computer with a fair value of \$180,000 from Harvest Corporation for Good Deal's existing computer having a fair value of \$200,000 and an undepreciated cost of \$160,000 recorded on its books. How much gain should Good Deal recognize on this exchange, and at what amount should the acquired computer be recorded, respectively?
    a. Zero and \$140,000.
    b. \$4,000 and \$144,000.
    c. \$20,000 and \$160,000.
    d. \$40,000 and \$180,000.

24. The measurement date in accounting for stock issued to employees in compensatory stock option plans is
    a. The date on which options are granted to specified employees.
    b. The earliest date on which both the number of shares to be issued and option price are known.
    c. The date on which the options are exercised by the employees.
    d. The date the corporation foregoes alternative use of the shares to be sold under option.

25. How should any compensation involved in a compensatory employee stock option plan be expensed?
    a. In the period in which the options are exercised.
    b. In the period containing the measurement date.
    c. Proportionately in the time interval between the measurement date and the exercise date.
    d. In the period(s) in which related services are performed.

26. Minimum disclosure requirements for companies issuing interim financial information would include which of the following?
    a. An interim statement of financial position and statement of changes in financial position data.
    b. Primary and fully diluted earnings per share data for each period presented.
    c. Sales and cost of goods sold for the current quarter and the current year-to-date.
    d. The contribution margin by product line for the current quarter and the current year-to-date.

27. Which of the following reporting practices is permissible for interim financial reporting?
    a. Use of the gross-profit method for interim inventory pricing.
    b. Use of the direct-costing method for determining manufacturing inventories.
    c. Deferral of unplanned variances under a standard-cost system until year end.
    d. Deferral of inventory market declines until year end.

28. How should the gain or loss from an event or transaction that meets the criteria for infrequent occurrence but **not** unusual nature be disclosed?
    a. Separately in the earnings statement immediately after earnings from continuing operations.
    b. On a net-of-tax basis in the earnings statement immediately after earnings from continuing operations.
    c. As an extraordinary item and treated accordingly in the earnings statement.
    d. Separately in the earnings statement as a component of earnings from continuing operations.

29. Which of the following is a required disclosure in the earnings statement when reporting the disposal of a segment of the business?
   a. The gain or loss on disposal should be reported as an extraordinary item.
   b. Results of operations of a discontinued segment should be disclosed immediately below extraordinary items.
   c. Earnings per share from both continuing operations and net earnings should be disclosed on the face of the earnings statement.
   d. Revenue and expenses applicable to the discontinued operations should be disclosed in the earnings statement.

30. How should research and development costs be accounted for according to a Financial Accounting Standards Board Statement?
   a. Must be capitalized when incurred and then amortized over their estimated useful lives.
   b. Must be expensed in the period incurred unless contractually reimbursable.
   c. May be either capitalized or expensed when incurred, depending upon the facts of the situation.
   d. Must be expensed in the period incurred unless it can be clearly demonstrated that the expenditure will have significant future benefits.

Items 31 through 40 relate to state and local governmental units.

31. What type of account is used to earmark the fund balance to liquidate the contingent obligations of goods ordered but **not** yet received?
   a. Appropriations.
   b. Encumbrances.
   c. Obligations.
   d. Reserve for encumbrances.

32. Premiums received on general obligation bonds are generally transferred to what fund or group of accounts?
   a. Debt service.
   b. General long-term debt.
   c. General.
   d. Special revenue.

33. Self-supporting activities that are provided on a user charge basis are accounted for in what fund?
   a. Agency.
   b. Enterprise.
   c. Intragovernmental service.
   d. Special revenue.

34. A statement of changes in financial position is prepared for which fund?
   a. Enterprise.
   b. Intragovernmental service.
   c. Special assessment.
   d. Trust.

35. A city should record depreciation as an expense in its
   a. General fund and enterprise fund.
   b. Intragovernmental service fund and general fixed-assets group of accounts.
   c. Enterprise fund and intragovernmental service fund.
   d. Enterprise fund and capital-projects fund.

36. Authority granted by a legislative body to make expenditures and to incur obligations during a fiscal year is the definition of an
   a. Appropriation.
   b. Authorization.
   c. Encumbrance.
   d. Expenditure.

37. An account for expenditures does **not** appear in which fund?
   a. Capital projects.
   b. Enterprise.
   c. Special assessment.
   d. Special revenue.

38. Part of the general obligation bond proceeds from a new issuance was used to pay for the cost of a new city hall as soon as construction was completed. The remainder of the proceeds was transferred to repay the debt. Entries are needed to record these transactions in the
   a. General fund and general long-term debt group of accounts.
   b. General fund, general long-term debt group of accounts, and debt-service fund.
   c. Trust fund, debt-service fund, and general fixed-assets group of accounts.
   d. General long-term debt group of accounts, debt-service fund, general fixed-assets group of accounts, and capital-projects fund.

39. Cash secured from property tax revenue was transferred for the eventual payment of principal and interest on general obligation bonds. The bonds had been issued when land had been acquired several years ago for a city park. Upon the transfer, an entry would **not** be made in which of the following?
   a. Debt-service fund.
   b. General fixed-assets group of accounts.
   c. General long-term debt group of accounts.
   d. General fund.

40. Equipment in general governmental service that had been constructed ten years before by a capital-projects fund was sold. The receipts were accounted for as unrestricted revenue. Entries are necessary in the

   a. General fund and capital-projects fund.
   b. General fund and general fixed-assets group of accounts.
   c. General fund, capital-projects fund, and enterprise fund.
   d. General fund, capital-projects fund, and general fixed-assets group of accounts.

Number 3 (Estimated time — 25 to 30 minutes)

An accountant must be familiar with the concepts involved in determining earnings of a business entity. The amount of earnings reported for a business entity is dependent on the proper recognition, in general, of revenue and expense for a given time period. In some situations, costs are recognized as expenses at the time of product sale; in other situations, guidelines have been developed for recognizing costs as expenses or losses by other criteria.

Required:

a. Explain the rationale for recognizing costs as expenses at the time of product sale.

b. What is the rationale underlying the appropriateness of treating costs as expenses of a period instead of assigning the costs to an asset? Explain.

c. In what general circumstances would it be appropriate to treat a cost as an asset instead of as an expense? Explain.

d. Some expenses are assigned to specific accounting periods on the basis of systematic and rational allocation of asset cost. Explain the underlying rationale for recognizing expenses on the basis of systematic and rational allocation of asset cost.

e. Identify the necessary conditions in which it would be appropriate to treat a cost as a loss.

Number 4 (Estimated time — 25 to 30 minutes)

Dhia Products Company was incorporated in the State of Florida in 1960 to do business as a manufacturer of medical supplies and equipment. Since incorporating, Dhia has doubled in size about every three years and is now considered one of the leading medical supply companies in the country.

During January 1971, Dhia established a subsidiary, Ban, Ltd., in the emerging nation of Shatha. Dhia owns 90% of the outstanding capital stock of Ban; the remaining 10% of Ban's outstanding capital stock is held by Shatha citizens, as required by Shatha constitutional law. The investment in Ban, accounted for by Dhia by the equity method, represents about 18% of the total assets of Dhia at December 31, 1974, the close of the accounting period for both companies.

Required:

a. What criteria should Dhia Products Company use in determining whether it would be appropriate to prepare consolidated financial statements with Ban, Ltd., for the year ended December 31, 1974? Explain.

b. Independent of your answer to **a.**, assume it has been appropriate for Dhia and Ban to prepare consolidated financial statements for each year 1971 through 1974. But before consolidated financial statements can be prepared, the individual account balances in Ban's December 31, 1974, adjusted trial balance must be translated into the appropriate number of United States dollars. For each of the ten (10) accounts listed below, taken from Ban's adjusted trial balance, specify what exchange rate (for example, average exchange rate for 1974, current exchange rate at December 31, 1974, etc.) should be used to translate the account balances into dollars and explain why that rate is appropriate. Number your answers to correspond with each account listed below.

1. Cash in Shatha National Bank.
2. Trade accounts receivable (all from 1974 revenues).
3. Supplies inventory (all purchased during the last quarter of 1974).
4. Land (purchased in 1971).
5. Short-term note payable to Shatha National Bank.
6. Capital stock (no par or stated value and all issued in January 1971).
7. Retained earnings, January 1, 1974.
8. Sales revenue.
9. Depreciation expense (on buildings).
10. Salaries expense.

c. Identify the standards of financial statement disclosure of foreign currency translations that Dhia must consider as required by the Financial Accounting Standards Board Statement No. 1.

Number 5 (Estimated time — 25 to 30 minutes)

Part a. Wright Aircraft Company manufactures small single and multiple-engine aircraft primarily for sale to individuals, flying clubs, and corporations. Wright is one of the pioneers in the industry and has developed a reputation as a leader in small-craft engineering and marketing innovations.

During the last few years Wright has profitably leased an increasing number of its aircraft to flying clubs. The leasing activity currently represents a significant portion of Wright's annual volume. Details of the leasing arrangements with flying clubs follow:

- The flying club signs a long-term lease agreement with Wright for the aircraft.
- The lease has a noncancelable term of six to eighteen years, depending on the aircraft's useful life. The lease term is set to be three-fourths of the normal life of the aircraft leased.
- The club is required to deposit with Wright an amount equal to 10% of the total lease rental for the term of the lease. The deposit is not refundable, but it is used in lieu of rent during the last one-tenth of the lease term.
- A bank loans Wright an amount equal to the remaining 90% of the total lease rental, after deducting a discount of 14% per year. The net discounted amount is immediately paid to Wright. The bank-loan agreement requires Wright to use the lease rental payments from the flying club to pay off the loan to the bank.
- As a condition for the loan, the bank requires Wright to insure the leased aircraft for an amount equal to the loan.
- The flying club signs Wright's bank-loan agreement as a surety, thus obligating itself if Wright should default on the loan.
- When the bank loan is paid in full at the end of the lease term, the flying club can purchase the aircraft and receive title to it by paying Wright $100.

Required:

Discuss the criteria and other aspects of Wright's leasing activities which it should consider in determining whether to account for its flying club leases as operating leases or as sales. In your discussion, identify criteria which are clearly met in the facts presented in the question. For criteria which are **not** clearly met, indicate what additional information is needed to reach a conclusion with respect to each criterion.

Part b. Cannon, Inc., was incorporated in 1974 to operate as a computer software service firm with an accounting fiscal year ending August 31. Cannon's primary product is a sophisticated on-line inventory-control system; its customers pay a fixed fee plus a usage charge for using the system.

Cannon has leased a large, BIG-I computer system from the manufacturer. The lease calls for a monthly rental of $30,000 for the 144 months (12 years) of the lease term. The estimated useful life of the computer is 15 years.

Each scheduled monthly rental payment includes $5,000 for full-service maintenance on the computer to be performed by the manufacturer. All rentals are payable on the first day of the month beginning with August 1, 1975, the date the computer was installed and the lease agreement was signed.

The lease is noncancelable for its 12-year term, and it is secured only by the manufacturer's chattel lien on the BIG-I system. On any anniversary date of the lease after August 1980, Cannon can purchase the BIG-I system from the manufacturer at 75% of the then current fair value of the computer.

This lease is to be accounted for by the lease-purchase method by Cannon, and it will be depreciated by the straight-line method with no expected salvage value. Borrowed funds for this type of transaction would cost Cannon 12% per year (1% per month). Following is a schedule of the present value of $1 for selected periods discounted at 1% per period when payments are made at the beginning of each period.

Periods (months)	*Present Value of $1 per Period Discounted at 1% per Period*
1	1.000
2	1.990
3	2.970
143	76.658
144	76.899

Required:

Prepare, in general journal form, all entries Cannon should have made in its accounting records during August 1975 relating to this lease. Give full explanations and show supporting computations for each entry. Remember, August 31, 1975, is the end of Cannon's fiscal accounting period and it will be preparing financial statements on that date. **Do not prepare closing entries.**

Number 6 (Estimated time –– 25 to 30 minutes)

Presented below are four independent questions concerning a typical manufacturing company that uses a process-cost accounting system. Your response to each question should be complete, including simple examples or illustrations where appropriate.

Required:

a. What is the rationale supporting the use of process costing instead of job-order costing for product-costing purposes? Explain.

b. Define equivalent production (equivalent units produced). Explain the significance and use of equivalent production for product-costing purposes.

c. Define normal spoilage and abnormal spoilage. Explain how normal-spoilage costs and abnormal-spoilage costs should be reported for management purposes.

d. How does the first-in, first-out (FIFO) method of process costing differ from the weighted-average method of process costing? Explain.

Number 7 (Estimated time –– 25 to 30 minutes)

Part a. There have been considerable discussion and research in recent years concerning the reporting of changes in financial position (sources and applications of funds). Accounting Principles Board Opinion No. 19 concluded

> . . . That the statement summarizing changes in financial position should be based on a broad concept embracing all changes in financial position and that the title of the statement should reflect this broad concept. The Board therefore recommends that the title be Statement of Changes in Financial Position.

Required:

1. What are the two common meanings of "funds" as used when preparing the statement of changes in financial position? Explain.
2. What is meant by " . . . a broad concept embracing all changes in financial position . . . " as used by the Accounting Principles Board in its Opinion No. 19? Explain.

Part b. Chen Engineering Company is a young and growing producer of electronic measuring instruments and technical equipment. You have been retained by Chen to advise it in the preparation of a statement of changes in financial position. For the fiscal year ended October 31, 1975, you have obtained the following information concerning certain events and transactions of Chen.

1. The amount of reported earnings for the fiscal year was \$800,000, which included a deduction for an extraordinary loss of \$93,000 (See item 5 below).
2. Depreciation expense of \$240,000 was included in the earnings statement.
3. Uncollectible accounts receivable of \$30,000 were written off against the allowance for uncollectible accounts. Also, \$37,000 of bad debts expense was included in determining earnings for the fiscal year, and the same amount was added to the allowance for uncollectible accounts.
4. A gain of \$4,700 was realized on the sale of a machine; it originally cost \$75,000 of which \$25,000 was undepreciated on the date of sale.
5. On April 1, 1975, a freak lightning storm caused an uninsured inventory loss of \$93,000 (\$180,000 loss, less reduction in income taxes of \$87,000). This extraordinary loss was included in determining earnings as indicated in 1. above.
6. On July 3, 1975, building and land were purchased for \$600,000; Chen gave in payment \$100,000 cash, \$200,000 market value of its unissued common stock, and a \$300,000 purchase-money mortgage.
7. On August 3, 1975, \$700,000 face value of Chen's 6% convertible debentures were converted into \$140,000 par value of its common stock. The bonds were originally issued at face value.
8. The board of directors declared a \$320,000 cash dividend on October 20, 1975, payable on November 15, 1975, to stockholders of record on November 5, 1975.

Required:

For each of the eight (8) numbered items above, explain whether each item is a source or use of working capital and explain how it should be disclosed in Chen's statement of changes in financial position for the fiscal year ended October 31, 1975. If any item is neither a source nor a use of working capital, explain why it is **not** and indicate the disclosure, if any, that should be made of the item in Chen's statement of changes in financial position for the fiscal year ended October 31, 1975.

INDEX

HOW TO USE THIS INDEX: This index includes an examination and question number reference in addition to the normal page reference. This examination and question number reference is in parentheses immediately preceding the page reference (e.g., Accountant's legal liability (N74L-5) *94*). The initial letter of the reference identifies the May or November examination, the next two numbers identify the year and are followed by the section of the examination identified as follows: A—Auditing, L—Business Law, T—Theory, PI—Accounting Practice–Part I, and PII—Accounting Practice–Part II. The first number after the dash identifies the question number. In the case of multiple choice questions this is followed by the item number and an "m" which means multiple choice.

A

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    Depreciation
      For improvements, replacement and expansion of plant, it would be most desirable to transfer cash from the operating fund to the plant fund in amounts at least equal to depreciation (N74PI-2-33m) *58*
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      Inventory and write down to their value (N74-2-32m) *58*

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    To investors
      Major categories of revenue, expense, and other items included (N74T-4) *103*
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Independence
  See also General standards
  Auditor may not supervise the taking of the annual physical inventory (M75A-1-21m) *132*
  CPA not independent precluded from expressing opinion because any audit procedures he might perform would not be in accord with GAAS (M74A-1-2m) *23*
  Management services
    Independence impaired by supervising the management of client's activities (N74A-2-28m) *79*
  Must be without bias with respect to client (M75A-1-2m) *130*
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Independent audit
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Infrequent but not unusual gain or loss disclosure (N75T-2-28m) *209*

Installment sales
  Compute balance of deferred-gross-profit control account given two years installment sales, two years cost of installment sales, and cash collection on sales by year (N74PII-1-13m) *67*
  Compute loss on repossession given the installment sales, cost of installment sales, balance of the installment receivable, and the fair value of repossessed merchandise (N74PII-1-14m) *67*

Installment sales *(cont.)*
Deferred income tax
Amount recorded as result of sale of machinery (M74PII-1-4m) *11*
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Insurance
Each of three partners took out a life insurance policy on the life of each of his other two partners, the proceeds of which were to be used to purchase one-half any decedent's estate for each of the remaining partners with the result that on the death of a partner, the estate of the decedent could validly transfer the policy it held on the life on one surviving partner to the other surviving partner (M74L-3-50m) *40*
Fire
Recovery
Computation of recovery from each insurance company with one policy on building and one on building and equipment and a loss applicable to each asset category (N74PI-5) *62*
Computation for building insufficiently insured under a coinsurance clause (partially damaged by fire) (M74L-3-38m) *38*
Computation for total loss of a building underinsured according to the coinsurance requirement (M74L-3-54m) *41*
Multiple carrier coverage (N75L-3-38m) *200*
If, prior to a loan secured by an assignment of an insurance policy naming a beneficiary, that beneficiary had been named irrevocably as beneficiary without consideration, he will be entitled to the entire proceeds absent his consent to any change in his rights (M74L-3-44m) *39*
"Incontestable clause" in life insurance usually provides that if death occurs after a specified period, a misstatement in the application will not constitute a defense by the insurer (M74L-3-51m) *41*
Insurable interest
Leasehold is an insurable interest (M75L-2-32m) *145*
Must exist at time of loss in property insurance (N75L-3-40m) *201*
Not identical for life and property insurance (N75L-3-40m) *201*
Purchaser took possession of factory and warehouse prior to closing, thereby incurred the risk of loss which created an insurable interest for which he may recover for its loss (N74L-7) *96*
Malpractice insurance company will not be subrogated to rights against the insured for his negligent conduct (M74L-3-53m) *41*
"Split-dollar" life insurance usually refers to a life insurance contract where an employer of the insured pays the portion of the premium equal to the increase in cash surrender value of the policy and the employer's interest in the proceeds is limited to this amount (M74L-3-52m) *41*
Where an insured owns a life insurance policy on his life and has borrowed against it without repaying the loan at the time of his death, the insurer may withhold the amount of the loan and interest from proceeds otherwise payable on the insured's death even though after the loan the policy was assigned for consideration to a third party who had no notice of the loan (M74L-3-45m) *40*

Interest expense
Computation of amount of interest recorded in a capitalized lease equivalent to a purchase, given capitalized value, prevailing interest rate, amount of each payment, and that first payment is made at beginning of the lease (M75PII-1-6m) *121*

Interim financial reporting
Disclosure requirements (M75T-3) *157*
Primary and fully diluted earnings per share (N75T-2-26m) *209*
Gross-profit method for inventory pricing (N75T-2-27m) *209*
Preferable treatment with explanations for each of five given items (M75T-3) *157*
Unaudited
Prohibition of inclusion of internal-control report in a document to stockholders if the document contains only the internal-control report and unaudited interim financial statements (N74A-1-6m) *76*
Weaknesses identified in form and content of given interim report (M75T-3) *157*

Internal control
See also Electronic data processing
Access to securities in the company's safe deposit box should not be assigned to only one employee (M74A-29m) *27*
Accounting control
Electronic data processing aspects
Evaluation (N75A-3-48m) *190*
Actual operation of the system most objectively evaluated by selection of items processed by the system and determination of the presence or absence of errors and compliance deviations (N74A-1-12m) *76*
Audit committee
Membership (N75A-3-47m) 190
Cancel vouchers and supporting papers when payment is made to prevent fraud described (M74A-2-26m) *26*
Cash
Weak internal control
Proof of cash (N75A-3-49m) *190*
Cash receipts and disbursement procedures
Of various weaknesses checks being signed by only one person would cause less concern than signed checks being distributed by the controller to approved payees, the treasurer failing to establish *bona fides* of names and addresses of check payees, or cash disbursements being made directly out of cash receipts (M75A-1-25m) *133*
Compliance tests (N75A-3-58m) *191*
Credit department should approve credit before shipment to prevent increasing uncollectible accounts (M74A-2-30m) *27*
Electronic data processing
Combination check
Card rejected because sales clerk whose identification number appears on the card does not work at store indicated on the card (N74A-2-46m) *81*
Input edit run (N74A-2-47m) *81*
Valid-character check
Card rejected because last letter of customer's name is erroneously entered in an amount column (N74A-2-47m) *81*
Have a paymaster who has no other payroll responsibility distribute the payroll checks to prevent fraud described (M74A-2-33m) *27*
Heavy equipment
Primary purpose (N75A-3-54m) *190*
Procedures (N75A-3-59m) *191*
Purchasing
Keep an adequate record of open purchase orders and review it before ordering to prevent excess ordering (M74A-2-43m) *28*
Weaknesses in flowcharted functions (N75A-6) *192*

Internal control *(cont.)*
Receiving
Prepare and numerically control receiving reports for all materials received to prevent errors such as the one described relative to a cutoff error as a result of an unrecorded sales return (M74A-2-27m) *26*
Require receiving reports to support all credit memorandums to prevent fraud described (M74A-2-28m) *27*
Report
CPA may omit a major weakness from his report, when he and management agree that there is no practicable corrective action, but should clearly state that the report is restricted to material weakness for which corrective action by management may be practicable in the circumstances (M75A-2-33m) *134*
Differences in the form and content of an internal control report if it were based on a special study for the purpose of reporting to a regulatory agency (as opposed to a report to management based on the annual audit) (M74A-5) *30*
Explain to client that engagement for a special study of a proposed modification of the system can be accepted if it will not require decisions on the part of the CPA which would impair his independence in connection with future audits (N74A-1-17m) *77*
Form and content based on annual report and the reasons for such a report (M74A-5) *30*
General public to receive
Must specifically include the objective of internal accounting controls (N74A-1-7m) *76*
Governmental agency responsible for a grant has written criteria for such a report, client must have such a report prepared, CPA finds material weakness in accounting for the grant not covered by the criteria and must include the weakness in his report (M75A-2-26m) *133*

Internal control reports
Based on audits
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Omission of year audited (N75A-1-18m) *186*
Statement implying that the evaluation would also apply to the next fiscal year (N75A-1-20m) *186*
Statement that cost may exceed benefits (N75A-1-19m) *186*
First paragraph (N75A-1-18m) *186*
Scope limitation
Qualified opinion
Scope limitation also indicated in report on internal control (N75A-1-22m) *187*
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Third paragraph (N75A-1-20m) *186*
General creditors would find this report less useful than would regulatory agencies, management, or internal auditors (M75A-1-3m) *130*
Issuance limitations
Not sent to stockholders with unaudited interim financial statements (N75A-2-21m) *187*
Stockholders to receive
Must include the date of the financial statements and the date of the audit report issued on those financial statements (N74A-1-8m) *76*
Prohibition of inclusion in a document to stockholders if the document contains only the internal-control report and unaudited interim financial statements (N74A-1-6m) *76*
Should discuss the risk involved in making projections about the future adequacy of the company's internal control (N74A-1-9m) *76*

Internal control reports *(cont.)*
Sampling
Objective of sampling transactions from a large-volume population is to determine whether controls are actually operative (N74A-5) *82*
Study and evaluation
First, prepare an internal-control questionnaire or a flow chart of the system, and, second, gather enough evidence to determine the system is functioning as it should (M74A-2-45m) *28*
Generally accepted auditing standards requires consideration of accounting controls (as opposed to administrative controls) (M75A-2-28m) *133*
Independent auditor's principal purpose for conducting a study and evaluation of the system is to determine the nature, timing, and extent of subsequent audit work (N74A-1-11m) *76*
Preliminary evidence-gathering assisted by tracing a single-transaction of each of various types through all stages of the accounting system (N74A-5) *82*
Primary concern is the reliability of the accounting information system (M74A-2-41m) *28*
Walk through (N74A-5) *82*
System
Quarterly audits by an insurance company to determine the premium for workmen's compensation insurance would be less important as a part of a manufacturing company's "system" of internal control than time and motion studies of an engineering nature, a budgetary system installed by a consulting firm, or a training program designed to aid personnel in meeting their job responsibilities (M75A-1-24m) *132*
Use predetermined totals to control posting routines to prevent errors such as posting too little to sales and a customer's account (M74A-2-44m) *28*

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Interstate Land Development Corporation (M75L-5) *149*

Inventory
Audit procedures
Consignments out (N74A-3) *82*
Finished merchandise in public warehouses pledged as collateral for outstanding debt (N74A-3) *82*
Average inventory computation (M74PI-1-4m) *2*
Basis
May be stated at price in a current purchase, as in applying lower of cost or market (N74T-2-36m) *102*
Basis for valuation
Accept historical cost, replacement cost, or current selling price less cost of disposal in some circumstances (N74T-2-34m) *102*
Prime cost not acceptable (N74T-2-34m) *102*
Cost of goods sold
Three different computations based upon FIFO, LIFO, and weighted average (N74PII-3) *70*
Explanation of effect on cost of goods sold and any other account affected of each of eight items relating to inventory (M75T-5) *159*
FIFO requires that earnings be plowed back into inventories during periods of rising prices if inventory quantities are to be maintained (N74T-2-22m) *100*
First audit
Unable to satisfy with respect to opening inventories of client not previously audited by a CPA
Disclaim or qualify on income statement and the statement of changes in financial position, but could issue an unqualified opinion on the balance sheet (N74A-1-3m) *75*

Inventory *(cont.)*
General purpose audit software packages (N75A-5) *192*
Gross-profit method
Computation of estimated inventory, given goods available, gross margin percentage, and sales for the year (M75PI-1-6m) *109*
Gross-profit method acceptable for interim financial reporting (N75T-2-27m) *209*
In-transit goods
Detection and disclosure (N74A-4) *82*
LIFO
Establishment of and subsequent pricing procedures for LIFO applied to units of product when the periodic inventory system is used and application of dollar-value method to a retail LIFO inventory or to LIFO units of product (M74T-5) *51*
General advantages and disadvantages of LIFO (M74T-5) *51*
Permits some control by management over the net income through controlled purchases, while FIFO does not (N74T-2-22m) *100*
Specific advantages and disadvantages of dollar-value-LIFO (M74T-5) *51*
Tends to smooth net income since it matches current costs with current revenue, when inventory quantities remain constant (N74T-2-22m) *100*
With a reduction of inventory may cause a matching of old costs with current revenue (N74T-2-22m) *100*
Lower of cost or market
Applied to work-in-process inventory, costs of completing the inventory are added to costs of disposal and both deducted from estimated selling price when computing realizable value (M74T-1-6m) *46*
Observation
Statistical test counts during the year rather than annual physical counts (N74A-1-1m) *75*
Auditor can issue unqualified opinion without disclosing that he did not observe year-end inventories (N74A-1-1m) *75*
Periodic
Trade discounts on purchases not considered in cost (N75T-1-1m) *207*
Perpetual
Physicial taken December 15, inventory control and detailed perpetual inventory adjust to agree that date, however sales-cutoff- test worksheet showing date shipped, date recorded as a sale, and date credited to inventory control indicates the need for adjusting entries except for item shipped and credited to inventory control prior to December 15 (M75A-1-17m) *132*
Qualified opinion
Ending inventory stated above cost to reflect recent increases in cost prices (N74A-1-4m) *75*
Retail method
Adaptable to LIFO (N74T-2-28m) *101*
Computation of amount (M74PII-1-14m) *13*
Computation of estimated inventory, given goods available at cost and retail, net markups, net markdowns, and sales (M75PI-1-7m) *109*
Conventional (N74PII-3) *71*, (N75PII-1-16 & 17m) *175*
Factors that may have caused a difference between the computed inventory and the physical count (N74PII-3) *71*
Includes net markups but not net markdowns in computing the cost-price percentage (N74T-2-28m) *101*

Inventory *(cont.)*
Lower ending inventory if net markups are included but net markdowns are excluded in computing the cost-price percentage (N74T-2-28m) *101*
Statistical sampling
CPA should observe, satisfy himself that the sampling plan has statistical validity, that it was properly applied, and that resulting precision and reliability are reasonable (M74A-1-5m) *23*
Thefts undiscovered
Failure to meet generally accepted auditing standards
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Valuation
Standard cost
Conceptual merits on financial statements (N74T-6) *104*
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Journal entries with conceptual merits for disposition of variances by charging cost of goods sold, by charging cost of goods sold and finished goods, and by charging finished goods only (N74T-6) *104*

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Investments
Acquisition of stock in another company in a noncash transaction would record cost at the fair value of the consideration given (M75T-1-19m) *155*
Adjusting entries necessary as result of analysis of account including gain on disposition of investments, allocation of costs between common and preferred, allocation of cost to rights, exercise of rights, equity method, cost method, purchase of bonds between interest dates, and treasury stock retirements (M75PI-3) *115*
Audit procedures (N75A-2-39m) *189*
Evidence (N75A-2-39m) *189*
Long-term
Accounts affected by carrying an investment at equity for the last six months of a fiscal period (N74T-3) *103*
Criteria based upon intent of management as to use of the funds (such as for dividend revenue, or for long-term appreciation, or for ownership-control), ease of disposal of the investment, etc. (N74T-3) *103*
Includes stock would like to sell, but serious question about its marketability except at sacrifice price (M74T-1-7m) *46*
Temporary
Basis
May be stated at price in a current sale, as in applying lower of cost or market (N74T-2-36m) *102*
Criteria based upon intent of management as to use of the funds (such as the funds invested are contingency funds available when needed, or an investment of temporarily idle funds, or a speculative investment), ease of disposal of the investment, etc. (N74T-3) *103*
Valuation
Audit procedures (N75A-2-39m) *189*
Evidence (N75A-2-39m) *189*
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Jared, Inc. (M75PII-5) *127*

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Kiting
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Kevin Instruments, Inc. (M75PI-3) *114*

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Land
  Cost
    Excludes property taxes accruing during the period of plant construction (N74T-2-30m) *102*
    Includes title examination fees, recording fees, surveying fees, grading, clearing, draining, and removing old, unwanted building (N74T-2-30m) *102*
    Nonmonetary exchange
      Computation of amount capitalized, given number of shares of treasury stock exchanged for land, market value of the treasury stock, and amount received as scrap when an existing building was removed (M75PII-1-1m) *120*
  Presentation on personal financial statements given appraised value date of inheritance and appraised current value (M75PII-1-11m) *121*

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Leases
  Accounted for as an operating lease
    Lessor entry at time of initial transaction (N75PI-1-16m) *164*
  Accounted for as an operating lease versus purchase
    Lessee difference in net income (N75PI-1-17m) *165*
  Accounted for as equivalent to a sale
    Lessor entry at time of initial transaction (N75PI-1-15m) *164*
  Capitalized
    Computation of interest expense and depreciation (M74PII-1-15m) *13*
  Disclosure by footnote would be best for the sublease at increased price of a leased asset for the remainder of the lease period (M75T-1-12m) *154*
  Entries under lease-purchase method (N75T-5) *212*
  Equivalent to a purchase
    Capitalized value of equipment, given the present value of an annuity in advance, the annual rental period and amount, that the lease is noncancelable, that title passes at the end of the rental period, and that the first payment was made at the beginning of the lease (M75PII-1-5m) *121*
    Computation of amount of interest, given capitalized value, prevailing interest rate, amount of each payment, and that first payment is made at beginning of the lease (M75PII-1-6m) *121*
  Installment sale equivalent
    Gross profit which should be recognized on the date of a lease by the lessor (M74PII-1-1m) *11*
  Lease-purchase method entries with explanations (N75T-5) *212*
  Manufacturers or dealer lessors sometimes sell or assign leases to third parties, usual independent financing companies, but involvement of such a company does not disqualify the lease from sale accounting treatment (M74T-2-26m) *48*
  Operating leases or sales (N75T-5) *212*
  Operating method of accounting used where the statement of financial position indicates that a portion of the property, plant, and equipment and of the related accumulated depreciation pertains to equipment leased (M75T-1-7m) *154*

Leases *(cont.)*
  Sale presumption of a manufacturer or dealer lessor will be invalidated by the lessor retaining a material contingent residual interest in the lease property (M74T-2-33m) *49*
  Treated as installment purchases, amortization would be appropriate to the asset without regard to the period of the lease (M75T-1-8m) *154*

Legal liability of accountants
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Lessor
  Manufacturer or dealer
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