1957

Unofficial answers to the uniform certified public accountants examination of the American Institute of Accountants, May 1954 to November 1956

American Institute of Accountants

UNOFFICIAL ANSWERS

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

MAY 1954 TO NOVEMBER 1956

UNOFFICIAL ANSWERS

.....To the Uniform Certified Public Accountants Examination of the American Institute of Accountants

MAY 1954 TO NOVEMBER 1956

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
270 Madison Avenue • New York 16, N. Y.

FOREWORD

The text of the Uniform Certified Public Accountant Examinations, prepared by the board of examiners of the American Institute of Accountants (now the American Institute of Certified Public Accountants) and adopted by the examining boards of 48 states, the District of Columbia, and 4 territories, are periodically published in book form. Unofficial answers to these examinations, which appear in THE JOURNAL OF ACCOUNTANCY from month to month have been concurrently published in separate volumes, of which this is the ninth. These books have been used in accounting courses in schools throughout the country, and have proved valuable to candidates for the CPA certificate.

Responding to a continuing demand, we now present a book of answers covering the period from May 1954 to November 1956. The problems and questions of this period appear in a separate volume which is being published simultaneously. It cannot be too strongly emphasized that these answers are not in any sense official. They represent merely the opinions of Fontaine C. Bradley, Louis A. Sigaud and Robert L. Kane, Jr., who have prepared them for publication.

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

July 1957

Contents

UNOFFICIAL ANSWERS TO COMPLETE EXAMINATIONS

	Page		Page
May, 1954	1	November, 1955	136
November, 1954	37	May, 1956	180
May, 1955	87	November, 1956	224

INDIVIDUAL SUBJECTS

Accounting Practice—Part I

May, 1954	1	November, 1955	136
November, 1954	37	May, 1956	180
May, 1955	87	November, 1956	224

Accounting Practice—Part II

May, 1954	11	November, 1955	145
November, 1954	45	May, 1956	190
May, 1955	98	November, 1956	236

Auditing

May, 1954	16	November, 1955	153
November, 1954	57	May, 1956	200
May, 1955	109	November, 1956	246

Commercial Law

May, 1954	24	November, 1955	163
November, 1954	67	May, 1956	210
May, 1955	117	November, 1956	257

Theory of Accounts

May, 1954	31	November, 1955	171
November, 1954	77	May, 1956	216
May, 1955	126	November, 1956	263

INDEX ---------- 271

Answers to Examinations, May, 1954

Accounting Practice—Part I

May 12, 1954; 1:30 to 6 p.m.

Solution 1

The schedule might present a comparison of the reported and computed cash as follows:

Cash balance, January 1, 1953		$ 4,470
Add cash derived from operations:		
Net profit per return	$5,780	
Depreciation per return	800	
Decrease in inventory	700	7,280
		$11,750
Deduct:		
Doe's drawings	$4,800	
Purchase of delivery truck	2,400	
Purchase of fixtures	1,050	
Decrease in liabilities	600	8,850
Derived cash balance, December 31, 1953		$ 2,900
Check book balance, December 31, 1953		7,020
Discrepancy, which is assumed to represent additional receipts which were not reported on the tax return		$ 4,120

The computation might present a comparison of the reported and computed change in the proprietorship interest as follows:

Proprietorship at First of Year (Exclusive of Fixed Assets)

Cash	$ 4,470
Inventory	9,500
Total	$13,970
Liabilities	4,500
Proprietorship (exclusive of fixed assets)	$ 9,470

Computed 12/31/53 Proprietorship (Exclusive of Fixed Assets) Based on Reported Income

Balance 1/1/53	$ 9,470
Reported profit	5,780
	$15,250
Drawings	4,800
Balance 12/31/53 using reported income (exclusive of 1/1/53 fixed assets)	$10,450

Proprietorship at End of Year (Exclusive of 1/1/53 Fixed Assets)

Cash	$ 7,020
Inventory	8,800
1953 asset additions less 1953 depreciation	2,650
Total	$18,470
Liabilities	3,900
Net worth 12/31/53	$14,570
Computed, based on reported income	10,450
Discrepancy	$ 4,120

Solution 2

ELECTRICAL APPLIANCE COMPANY

Balance Sheet, September 30, 1953

ASSETS

Current:			
Cash in bank			$ 3,100
Customers' accounts		$3,145	
Installment notes discounted	$5,325		
Less allowance for loss		250	2,895
Inventory of appliances at estimated cost (pledged to secure bank loan)			30,198
Inventory of used appliances at estimated market			550
Total current assets			$36,743

Fixed:

	Cost	*Depreciation*	*Net*	
Trucks	$5,400	$150	$5,250	
Shop equipment	300	5	295	
Office equipment	600	5	595	
Total fixed assets	$6,300	$160		6,140
				$42,883

LIABILITIES

Current:		
Bank loan		$15,000
Note to B		16,000
Income taxes withheld		250
Sales taxes		377
Payroll taxes		72
Collections received on discounted notes*		300
Accrued rent		420
		$32,419
Capital:		
Investment 9/1/53	$7,500	
Net income for September	2,964	
Balance 9/30/53		10,464
		$42,883

* Might be treated as a segregation of cash.

ELECTRICAL APPLIANCE COMPANY

Statement of Income and Expense, Month Ended September 30, 1953

Sales		$18,850
Less allowances		450
Net sales		$18,400
Cost of goods sold		11,310
Gross profit		$ 7,090
Operating expenses:		
Salaries and wages	$2,400	
Rent*	920	
Provision for loss on accounts and notes	250	
Shop supplies	135	
Miscellaneous office and general expense	125	
Heat, power and water	25	
Insurance	75	
Depreciation provision	160	
Payroll taxes	36	4,126
Net income		$2,964

* The company is obligated under a nine-year contract for the rent of the building it occupies. The agreement provides for a guaranteed minimum rental of $500 per month plus 5% of net sales in excess of $10,000 per month.

Note: The problem asks for a formal balance sheet and an income statement. As a part of such statements the existence of the contingent liabilities under the lease and under the notes discounted should be disclosed. Also disclosure is required as to the pledging of the inventory to secure bank loans. These disclosures may be made in the statements or by notes attached to the statements.

Computations

Sales:		
On notes and accounts including tax		$12,750
Cash sales including tax:		
Cash received	$ 6,120	
Trade-in allowed	357	6,477
Total (102%)		$19,227
Tax included		377
Gross sales		$18,850
Allowance in excess of market (45% of $1,000)		450
Net sales		$18,400

Provision for loss on accounts:
2% of credit sales ($12,750 ÷ 102) $12,500 = $250

Rent accrued:
5% on excess of net sales ($18,400) over $10,000 = $420

Customers' notes and accounts:

Credit sales:			
On account		$ 6,440	
Allowance on trade-in	$ 643		
Collections	2,652	3,295	$ 3,145
Installment notes		$ 6,310	
Finance charges		490	
Amounts of notes which were discounted		$ 6,800	
Collections		1,475	
Amount of contingent liability			$ 5,325

Inventory of appliances:

Purchase of merchandise from B		$27,833
Purchases from other vendors:		
Amount of disbursements	$31,808	
Amount arising from purchase from B ($34,133 less $16,000)	18,133	13,675
Total purchases		$41,508
Cost of goods sold		11,310
Inventory 9/30/53 at estimated cost		$30,198

Solution 3

***a.* Computation of Gross Profit Percentages**

	1952	1953
Cash sales	$ 21,348	$ 29,180
Installment sales	188,652	265,320
Total	$210,000	$294,500
Cost of goods sold		
Inventory, January 1	$ —	$ 36,400
Purchases	154,000	173,585
	$154,000	$209,985
Inventory, December 31	36,400	48,010
Cost of goods sold	$117,600	$161,975
Gross profit	$ 92,400	$132,525
Gross profit percentage	44%	45%

The given solution was prepared on the assumption that the gross profit rates desired were those for new merchandise, since such rates are required for parts (c) and (d) of the problem. Furthermore, the company treats the sale of repossessed goods as an offset to defaults charged to "Bad Debt Expense." Considering part (a) alone, the inclusion of repossessed items may be appropriate to arrive at total gross profit percentages for use in other connections. However, complete cost data for repossessed goods is not available for a satisfactory computation of such total rates even if they were desired.

***b.* Ledger Accounts——Installment Contracts Receivable**

1952 Installment Contracts Receivable

*1/1/52 - 12/31/52 Sales	$125,768	*1/1/52 - 12/31/52 Collections	$ 42,943
		1/1/52 - 12/31/52 Defaults	2,865
		Balance 12/31/52	79,960
	$125,768		$125,768
1/1/53 Balance	$ 79,960	1/1/53 - 12/31/53 Collections	$ 61,385
		1/1/53 - 12/31/53 Defaults	3,725
		Balance 12/31/53	14,850
	$ 79,960		$ 79,960
1/1/54 Balance	$ 14,850		

1953 Installment Contracts Receivable

*1/1/53 - 12/31/53 Sales	$176,880	*1/1/53 - 12/31/53 Collections	$ 55,960
		1/1/53 - 12/31/53 Defaults	3,010
		Balance 12/31/53	117,910
	$176,880		$176,880
1/1/54 Balance	$117,910		

* In the above accounts sales are recorded net of down-payments, and collections are exclusive of down-payments. An alternate treatment would show sales at gross amounts, with collections of down-payments recorded separately or as part of "collections."

***c.* Calculation of 1952 Net Loss on Defaulted Accounts**

Unpaid balances defaulted		$ 2,865.00
Deduct:		
Deferred gross profit (44%)	$1,260.60	
Sales	600.00	
Inventory at realizable value	150.00	2,010.60
Net loss		$ 854.40

***d.* Schedule of Realized Gross Profit for 1953**

Cash sales	$29,180 @ 45%	$ 13,131.00
Down payments	88,440 @ 45%	39,798.00
Collections on 1953 installment contracts	55,960 @ 45%	25,182.00
Collections on 1952 installment contracts	61,385 @ 44%	27,009.40
Total realized gross profit		$105,120.40

Solution 4

THE AMERICAN COMPANY

Consolidated Balance Sheet, December 31, 1953

ASSETS

Miscellaneous assets			$516,000

LIABILITIES AND CAPITAL

Miscellaneous liabilities			$110,000
Minority interest:			
Preferred stock (50%)	$50,000		
Cumulative dividends in arrears since 1949	7,500	$ 57,500	
Common stock (10%)	$20,000		
Retained earnings applicable to minority common	2,500	22,500	
Total minority interest			80,000
Excess of book value of stock of subsidiary acquired over cost		$ 34,000	
Preferred stock (4%)		100,000	
Common stock		100,000	
Consolidated retained earnings		92,000	
Total consolidated capital			326,000
			$516,000

Schedules and Comments

Minority Interest. A minority interest of 50% of the preferred stock and 10% of the common stock exists. The minority interest in the preferred should include the accumulated dividends on preferred since retained earnings exceed the amount of such dividends. Therefore, $15,000 of retained earnings are assignable to preferred in computing both minority interests.

Minority in preferred stock	50% of $100,000 = $50,000	
Minority interest in dividends in arrears	15% of $ 50,000 = $ 7,500	
Minority in common	10% of $200,000 = $20,000	
Minority in retained earnings	10% of ($40,000 — $15,000)	= $2,500

Excess of Book Value of Stock of Banner Corporation over Cost

Cost of preferred		$ 55,000
Book value of preferred		50,000
Excess of cost over book value		$ 5,000
Book value of common at acquisition:		
90% of $200,000	$180,000	
90% of $ 60,000 retained earnings	54,000	$234,000
Cost of common		195,000
Excess of book value over cost		$ 39,000

Since the $5,000 and the $39,000 seem to have arisen out of the same transaction, there would not be much question as to offsetting one against the other. However, the company treatment of this $34,000 which produced a credit to Retained earnings is unacceptable. The $34,000 should be identified separately on the consolidated balance sheet as arising from acquisition of the stock of Banner Corporation. Instead of using the net amount of $34,000, the $5,000 excess of cost over book value of preferred might be left as a charge against Retained earnings, leaving the $39,000 to be separately treated. If there is evidence indicating that specific assets of the subsidiary were overvalued at date of acquisition, the $39,000 might be treated as a reduction of such assets. Without such evidence the treatment of the amount as an identifiable item in the balance sheet's capital section is followed.

Consolidated Retained Earnings:

Retained earnings of The American Company		$150,000
Majority portion of retained earnings of the subsidiary ($40,000 — $10,000)		30,000
		$180,000
Deduct:		
Amount of write-up of investment included in American Company's retained earnings account	$34,000	
Amount of parent's share of subsidiary's retained earnings at date of acquisition	54,000	88,000
Consolidated retained earnings		$ 92,000

Solution 5

a.

Balance Sheet—Current Fund, December 31, 1953

Cash	$ 1,600
Advance for petty cash	500
Taxes receivable (net)	7,000
Stores inventory	2,400
	$11,500
Temporary loans payable	$ 5,000
Current surplus:	
Reserve for encumbrances	900
Reserve for petty cash advance	500
Reserve for stores	2,400
Unappropriated surplus	2,700
	$11,500

b.

The principal element involved in this portion of the problem is the appropriate classification of the amounts involved. Unlike corporation surplus statements, those for municipalities require display of current revenues, current expenditures and encumbrances (as those terms are used in municipal accounting) separate from other charges and credits which affect the surplus directly. Although the internal structure of the statement may be modified somewhat, the following statement meets the requirement mentioned.

Statement of Changes in Unappropriated Surplus
Year Ended December 31, 1953

Balance January 1, 1953				$2,900
Revenue for the year:				
Taxes	$83,000			
Other current revenues	16,000	$99,000		
Expenditures for the year:				
Expense and interest	$81,600			
Payment of bonds	10,000			
Purchase of fixed assets	4,000	95,600		
Excess of revenue over expenditures			$3,400	
Less encumbrances at end of year*			900	
Excess of revenue over expenditures and encumbrances				2,500
Total				$5,400
Add credit to surplus:				
Sale of equipment				600
Total				$6,000
Less charges to surplus:				
Taxes (non-current) written off			$ 300	
Creation of reserve for petty cash advance			500	
Creation of reserve for stores			2,400	
Excess of invoices on old encumbrances over reserve*			100	3,300
Balance December 31, 1953				$2,700

* These items might be shown in a section giving the 1952 encumbrances, actual expenditures as a result of the 1952 encumbrances, and the 1953 encumbrances; the net effect being shown as a $1,000 deduction from surplus.

Solution 6

a. In solving the items in this part of the problem, it seems desirable first to ascertain the precise nature of the "amount required" in each item (*i.e.*, PV of an amount, PV of an annuity, etc.). Then the appropriate tables may be selected by inspection or by testing their construction by means of formulas.

However, it appears that the items may be solved without recourse to formulas and without great familiarity with the tables, provided that certain basic facts about the tables' construction and functions are known. Since reference books which are generally available discuss formulas and the construction and use of tables adequately, the suggested answers below are accompanied by illustrations of other reasoning which might be used in selecting the appropriate tables.

Solving by this last approach requires the following knowledge concerning the tables. Mathematical tables of financial values are constructed for ease of use with a base of 1 ($1, £1 or other monetary unit). The value selected from a table for a given number of periods represents the value for $1 and must be multiplied eventually by the number of dollars involved to arrive at total value. The line designated "O" in a table provides the value at the *beginning* of the first interest period (at which time no interest has been earned). The succeeding numbered lines provide the values at the *end* of the number of interest priods indicated. Each line represents an annual interest period.

The desired amount for some of the problems could be obtained by using other than the tables suggested below only by taking additional arithmetical steps, so those indicated are the tables from which most directly usable values can be obtained. Use of any other table would be an indirect approach.

(1) C. This requires a table which shows a value of $1 at the *beginning* of the first period (time of deposit) and in which the periodic increments are 102% of the value for the preceding line in each case. Among those given, the only table which has those characteristics is Table C. (Amount of 1 at compound interest.)

(2) D. The amount required is one of a series of equal annual appropriations. Since the total appropriations and compound interest must provide (immediately after the last payment) the sum needed, the table to be used must show a value of $1 at the *end* of the first period (date of the first payment, which cannot have earned interest). It also must show decreasing values for succeeding periods, since the greater the number of payments to be made, the smaller each need be. Table D (Sinking fund deposits which will amount to 1) is the only table which meets these requirements.

(3) E. The amount to be determined is that which with its accumulated interest (compounded annually) will be sufficient to permit a certain number of equal annual withdrawals (called annuities or annual "rents"). Since these withdrawals begin one year from the date of deposit (by which time the deposit will have earned a full year's interest), that portion of the deposit necessary to provide the *first* annuity would be less than $1 (specifically $1 ÷ 1.02). This value would be the *present value* (at time of deposit) of an annuity of $1 withdrawn at the end of the first period. Therefore, the table selected should begin with the above value on line 1.

Each additional annuity to be provided from the single deposit would require that deposit to be greater than would be necessary for a smaller number of withdrawals. Thus, the values in the table might be expected to increase with succeeding periods (increasing number of annuities).

Inspection of the table shows that Table E (PV of an annuity of 1 at end of each period) is the only one with both of these characteristics. (Note that tables of annuities are constructed, unless designated otherwise, for the values of "ordinary annuities"—those payable at the *end* of periods, as in this problem—rather than for "annuities due," which are payable at the *beginning* of periods.)

(4) C. This item differs from item (1) in two respects only. In (1) the accumulated total of the deposit and compounded interest was required; while in (4) the amount of the accumulated compound interest only is required. In (1) interest is compounded annually; in (4) semi-annually.

Table C (Amount of 1 at compound interest) is suitable for solving both items most directly. The table gives the total deposit and accumulated interest at the end of each period. To find the amount of interest accumulated on $1 for any period, $1 may be deducted from the value of 1 for the appropriate number of periods.

Since the table is constructed for annually-compounded interest, to find the amount of semi-annually compounded interest, each half-year should be considered a period and the value should be sought in the *column* constructed for one-half the annual interest rate. When the value is found, $1 is deducted to remove the deposit from the value.

(5) A. The amount being paid now to settle a debt due in the future may be expected to be less than the total debt, since compound discount is allowed for early payment. If the debt were due *on* the date of payment, no discount would be appropriate and the "present value" (at date of payment) of the debt would be $1 for each dollar of the debt. Thus, the first characteristic of the table desired would be that it begins with a value of $1 on line *"O"* (*beginning* of first period).

The greater the time lapse between date of payment and due date, the greater the amount of compound discount and the smaller the payment required. Therefore, the values in the table selected must decrease with each succeeding period.

Table A (PV of $1 at compound interest) is the only table given which meets both requirements.

b. (1) The annual payments constitute a series of annuities. Since the accumulating fund has earned interest at the rate of 4% ($2,500 × 10.5828 = $26,457) and is expected to continue to do so, the total number of payments required from the beginning can be ascertained as follows:

$50,000 ÷ amount of one payment of $2,500 = $20, which is the required amount for $1. The annuity table shows that $1 will produce $20.0236 in 15 periods. Therefore, 14 full payments are required, plus an amount for the fifteenth somewhat less than $2,500.

Annual payments of $2,500 each for 15 periods would produce $50,059 ($2,500 × $20.0236). The final payment would be $2,441 ($2,500 — $59). Nine payments have been made, leaving five more full payments and a sixth of $2,441 that have to be made.

Alternately the solution can be obtained by starting with the present fund of $26,457 as follows:

Interest on $26,457 at 4% =	$1,058.28
Additional payment	2,500.00
Total payment into fund	$3,558.28

Funds required ($50,000 less $26,457) = $23,543.

$23,543 ÷ $3,558.28 = $6.6164. The annuity table shows this to be slightly less than the value for six payments. Six payments of $3,558.28 × $6.6330 equals $23,602, or an excess of $59 over the required $23,543. Therefore, five full payments and $2,441 for the sixth payment would be required.

(2) Eight payments would produce $184,284 ($20,000 × $9.2142), leaving $15,716 needed to produce the $200,000. The payment would be invested for eight full years. The amount of the payment may be computed as follows: $15,716 × $.7307 (present value) = $11,484; or it may be computed by dividing $15,716 by the amount of 1 ($1.3686) which equals $11,483.

Alternately this may be computed by discounting the $200,000 for eight periods ($.7307 × $200,000) giving a 1954 value of $146,140. The present value of the $20,000 annuity equals $134,654 ($6.7327 × $20,000), leaving a difference of $11,486.

The small differences are the result of using a four-place table, whereas six places are needed for complete accuracy.

Accounting Practice—Part II

May 13, 1954; 1:30 to 6 p.m.

Solution 1

a.	1	False	11	False	*b.*	1 c		*c.*	1 a		*d.*	1 yes
	2	False	12	True		2 e			2 d			2 no
	3	False	13	True		3 c			3 c			3 no one
	4	True	14	True		4 e			4 c			
	5	False	15	True					5 b			
	6	True	16	False	*e.*	1 $2,380 before 85 per cent dividend credit of $2,023						
	7	True	17	True		2 none						
	8	False	18	True		3 $2,040 before dividend credit of $1,445						
	9	False	19	False								
	10	False	20	True								

Solution 2

ABLE, CHARLES AND DOE

Statement of Source and Application of Funds
Year Ended December 31, 1953

Funds were derived from:		
Profit for year	$22,699	
Add—depreciation	2,103	$24,802
Admission of Doe as a partner		12,000
Sale of used equipment, excluding profit of $240		760
Cash value of life insurance		5,360
Total		$42,922
Funds were applied to:		
Retirement of Baker as a partner:		
Cash paid out	$ 4,000	
Note payable (current portion)	4,000	$ 8,000
Purchase of equipment:		
Cash paid to 12/31	$ 2,500	
Current portion of notes	2,400	4,900
Withdrawals by partners (including Baker $990)		21,290
Increase in cash value of life insurance		2,100
Total		$36,290
Increase in working capital (see schedule)		$ 6,632

ABLE, CHARLES AND DOE

Schedule of Changes in Working Capital, Year Ended December 31, 1953

	Balance 12/31/52	*Balance 12/31/53*	*Increase or (Decrease)*
Current assets:			
Cash	$ 3,675	$13,239	$ 9,564
Trade accounts receivable	3,241	5,526	2,285
Sundry receivables	420	100	(320)
Supplies and prepaid expenses	983	1,232	249
Notes receivable—trade	2,050	3,140	1,090
Total	$10,369	$23,237	$12,868
Current liabilities:			
Trade accounts payable	$ 2,680	$ 950	$ 1,730
Notes payable—Baker (current portion)	—	4,000	(4,000)
Bank loan	—	1,000	(1,000)
Installment notes (current portion)	—	2,400	(2,400)
Accrued expenses	1,406	1,972	(566)
Total	$ 4,086	$10,322	$(6,236)
Net working capital	$ 6,283	$12,915	$ 6,632

Supporting Computations for Statement

Computation of Net Profit for Year

Capital balances 1/1/53			$40,690
Add:			
Cash payment made by Doe		$12,000	
Goodwill allowed to Doe		1,311	13,311
			$54,001
Deduct:			
Cash and notes to Baker		$14,000	
Goodwill written off		5,000	
Withdrawals:			
Able	$7,200		
Baker	990		
Charles	8,400		
Doe	4,700	21,290	40,290
Balance			$13,711
Capital balances 12/31/53			36,410
Profit for the year			$22,699

Proof of Profit Computation

Profit 1/1 - 2/15	Per problem ($570 × 3)		$ 1,710
" 2/16 - 6/30	Per problem		8,212
" 7/1 - 12/31	Doe's balance 12/31	$12,870	
	Add withdrawals	4,700	
		$17,570	
	Less credit on investment	13,311	
	Doe's share of profit	$ 4,259	
		× 3	12,777
Net profit for 1953			$22,699

Analysis of Significant Accounts

Building and Equipment

Balance 1/1	$32,338	Retirement	$ 3,700
Addition	10,100	Balance 12/31	38,738
	$42,438		$42,438

Allowance for Depreciation

Write-off	$ 2,940	Balance 1/1	$14,211
Balance 12/31	13,374	Depreciation	2,103
	$16,314		$16,314

Cash Value of Life Insurance

Balance 1/1	$ 8,280	Cashed in	$ 5,360
Addition	2,100	Balance 12/31	5,020
	$10,380		$10,380

Solution 3

a. **REESE EXTRACT COMPANY**

Cost of Vanilla Extract Manufactured, Year Ended December 31, 1953

Percolating process:

	Units		*Amount*	*Per Unit*
In process, one-half complete 12/31/52	4 batches		$ 6,370	
Placed in process:				
Vanilla beans (1,100 × 130)	143,000 lbs.	@ $ .50	71,500	
Alcohol (360 × 130)	46,800 gals.	@ 2.00	93,600	
Alcohol lost (10 × 130)	1,300 gals.	@ 21.00	27,300	
Burden	102,400 gals.		32,832	$ .320625
Total			$231,602	
In process, one-half complete 12/31/53	8 batches		12,866	
Transferred to mixing	100,800 gals.		$218,736	$2.17

Mixing process:

	Units	*Amount*	*Per Unit*
In process (storage) 12/31/52	3,200 gals.	$ 6,268	
Transferred from percolating	100,800 gals.	218,736	$2.17
Total available for processing	104,000 gals.	$225,004	2.1635
In process (storage) 12/31/53	4,000 gals.	8,654	2.1635
Placed in process—45% strength	100,000 gals.	$216,350	2.1635
Water	25,000 gals.	—	—
Sugar	250,000 lbs.	12,500	.05
Burden	—	12,800	—
Extract manufactured—36% strength	125,000 gals.	$241,650	$1.9332

b. **Computation of Rebate for Taxes**

Gallons piped to packaging:	
In storage 12/31/52	2,000
Transferred from mixing	125,000
Total	127,000
In storage 12/31/53	2,500
Piped to packaging	124,500
Strength	36%
Gallons of alcohol	44,820
Rebate per gallon	$ 19
Rebate for year	$851,580

Computation of Tax Applicable to Inventories

In process, in percolating process:

Alcohol per batch when completed—800 × 45% = 360 gallons.

Recovery of alcohol in dryer—35 gallons per batch.

360 × 8 × $19 = $54,720 tax applicable to portion of inventory in percolating which will be completed.

35 × 8 × $20.50 = $5,740 tax applicable to inventory in percolating which will be returned to alcohol stock. The tax applicable to alcohol in stock is $20.50; so the deferable tax is at this rate rather than at $19.

In storage, in percolating process:

4,000 × 45% × $19 = $34,200

In storage, in mixing process:

2,500 × 36% × $19 = $17,100

Computations for *a.*

Computation of alcohol lost—percolating:

Alcohol put into a batch		405 gallons
Alcohol in a completed batch (800 × 45%)	360 gallons	
Alcohol recovered from dryer	35 gallons	
Total		395
Alcohol lost (which must be costed at $21.00 per gallon since there is no recovery of taxes)		10 gallons

Completed unit equivalents—percolating:

Batches in process, one half complete 12/31/52	4 × ½ =	2
Batches placed in process	130 × 1 =	130
		132
Batches in process, one-half complete, end of period	8 × ½ =	4
Batches fully processed (equivalent)		128 of 800 gallons

Valuation of in-process inventory—percolating:

Vanilla beans—8 × 1,100 lbs. × $0.50	$ 4,400
Alcohol—8 × 360 × $2.00	5,760
Alcohol lost—8 × 10 × $21	1,680
Burden—6400 × ½ × .320625	1,026
Total	$12,866

Proof of cost transferred—percolating:

Batches of 800 gallons. Transferred—126 less in-process 12/31/52 equals 122 batches started and completed.

Cost per batch:	Beans—1100 × $0.50 =	$ 550.00
	Alcohol—360 × $2.00 =	720.00
	Alcohol lost—10 × $21.00 =	210.00
	Burden—800 × .320625 =	256.50
	Total	$1,736.50

In process, 1st of year	$ 6,370
Cost to complete—4 × ½ × $256.50	513
Batches started and completed—122 × $1,736.50	211,853
Cost of transferred material	$218,736

Addition of water and sugar—mixing:

Original percentage of alcohol in mixture	45%
Percentage after dilution	36%

Percentage of alcohol decreases by 9% in the final mixture. Therefore, the water added equals 9/36 or 25% of the original mixture. 100,000 gallons transferred from storage (104,000 less ending inventory of 4,000) × 25% = 25,000 gallons of water and sugar added during the period.

Auditing

May 13, 1954; 9 a.m. to 12:30 p.m.

Solution 1

In view of the information given, the following adjusting entries would be necessary:

For the first item:		
Inventory control	$284	
Inventory variation		$284
For the third item:		
Sales	213	
Accounts Receivable		213
Inventory Control	189	
Cost of Sales		189

(Although no explanations were required of the candidates, the following may be of help to the student. Since the goods in the first item were shipped prior to the taking of the physical inventory, the Inventory control account was reduced by the cost of these goods in the adjustment which arose from the physical inventory. Since the client credited Inventory control for the cost of these goods on December 16, one of these two credits must be removed. The above entry reverses that made on December 15 with respect to these goods and leaves Cost of sales properly charged with the $284 as a result of the December 16 entry. The sales entry was made properly and requires no adjustment.

In the second item the client had reduced the control account at the date of shipment, prior to the taking of the physical inventory. The control was in agreement with the physical count on December 15 so far as these goods were concerned, and the December 15 adjustment did not relate to these goods. Since the accounts involved are in agreement with the facts at both December 15 and December 31, no adjustment is necessary.

The goods in the third item were shipped after the balance-sheet date and until shipment are the property of the client. Accordingly, it is necessary to reverse the sales and cost of sales entries made by the client on December 31 to avoid overstating sales and receivables and to state the inventory at the correct amount.)

Solution 2

a. The permanent file should include:

1. Conformed copies of or extracts from:
   (a) Certificate of incorporation
   (b) By-laws
   (c) Minutes of directors' meetings
   (d) Minutes of stockholders' meetings
   (e) Important continuing contracts
   (f) Indentures of bond and stock issues
   (g) Loan or other agreements
2. Brief history of company and description of its business
3. List of corporate affiliations with stock ownership in each
4. Summary of capital stock accounts from inception
5. Summary of surplus accounts from inception
6. Summary of fixed and intangible assets from inception
7. Summary of depreciation and amortization accounts from inception
8. Summary of any continuing miscellaneous reserves or deferred credits
9. Summary of any long-term deferred items
10. Summary of bonded debt from inception
11. Summary of investment account for each affiliate from inception
12. Information about predecessor businesses, if any
13. Internal control data, including notes on client's accounting procedures as appropriate
14. Summary of status of taxes for prior years
15. Comparative summaries of annual profit and loss statements or other historical financial data, as considered appropriate
16. List of officers, key employees and records commonly dealt with during an audit
17. Record of periods covered each year in tests of transactions, etc.

b. Among the advantages of a permanent file are these:

1. Accessibility—since the information is of such nature that reference to it may be required during several examinations, it is more easily located if maintained in special files than if scattered through current working papers of the annual examinations.
2. Aid to memory—points of continuing importance, such as restrictive provisions in agreements or indentures, may be brought to mind by review of the permanent file.
3. Orientation of new personnel—seniors and assistants who are new on the audit may orient themselves more quickly by review of such matters as the procedure files and list of records encountered during the audit.

Solution 3

a. 1. In connection with the testing of the payroll, the employee deduction for payroll taxes should be tested.
2. The amounts withheld for payroll taxes from the periodic payrolls should be test-checked to the accrued payroll taxes.
3. In testing the total employer's and employees' contribution, an analysis of the total payroll by states should be reviewed. From the comparable includible compensation, the mathematical accuracy of the payroll tax accrued can be verified.
4. The contra expense accounts should be analyzed for reclassification purposes.
5. All payments should be checked to cash disbursements and copies of the tax return.
6. With reference to state payroll taxes, it should be ascertained that client has adequate procedures regarding:
   (a) the location of employees for purposes of determining liability to individual states for payroll taxes;
   (b) constant verification of employer's experience rating, which includes the checking of reserve balances in the state fund, the propriety of payments by the state which are charged against the fund, proper credits for payments into the fund, as well as the desirability of making voluntary contributions to the fund to improve the rating if this option is available under applicable state law.
7. The year-end accrual should be checked to the subsequent payment made after the close of the year.
8. If this is the first audit, it should be established by inquiry and inspection of the previous years' returns depending upon the applicable statute of limitations that there is no liability for state or federal payroll taxes.

(*Note*: The foregoing steps may be carried out on a test basis if all surrounding circumstances indicate that this is appropriate.)

b. 1. The primary purpose of the analysis is to establish the accuracy of the year-end accrual.
2. The verification of the payroll tax deduction and payments serves as an additional check upon the accuracy of the whole payroll. The necessity for filing returns makes defalcations through fraudulent payroll practices more difficult. However, non-existing persons or persons who no longer are employees may be continued on the records and tax deductions made.
3. Due to the severe penalties which can be imposed by the federal and state governments for failure to file or incorrect filing, the verification of taxpayer's practices and computations is important.
4. Payroll tax expense must be separately stated in federal and state income and franchise tax returns as well as in S.E.C. financial statements.
5. Total compensation must be separately stated in federal and state income and franchise tax returns. In addition, the payroll analysis by states is necessary in most instances for computation of the income allocation formula for state income and franchise tax returns.

Solution 4

a. Because there are several acceptable ways of recording and reporting many financial transactions, failure to be consistent from year to year in the selection of procedures followed would destroy comparability of statements. Perhaps more serious is the possibility that by freely changing procedures it would be possible to switch income arbitrarily from one year to another at will. Therefore, it is important for the auditor to report lack of consistency and if possible disclose the effect of the inconsistency on the statements. Whether a qualification is necessary depends upon the auditor's judgment.

b. In general a change in the application of accounting principles does not necessitate the denial of an opinion by the auditor. While denial of an opinion may be required where the new principle applied is not considered acceptable, such denial is based on the non-acceptability of the principle followed rather than on the lack of consistency. Since with the possible exception of case 3, none of the four cases given seem to involve the use of an unacceptable principle, there is no reason for not giving an opinion. Yet disclosure or qualification as to consistency may be required.

Case 1 is clearly of the type where a qualification as to consistency usually is considered necessary. Probably LIFO is acceptable in the situation described. The wording might be as follows: "in conformity . . . applied on a basis consistent with that of the preceding year except for the change, which we approve, in the basis of raw material inventory valuation as described in Note—." The note would describe the inventory to which the change applied and state the effect ($435,000) on inventory and the resulting effect, after taxes, on income. The information in the note could be made a part of the auditor's report if such procedure seemed preferable.

Case 2 does not appear to require disclosure. The amount which would have been deferred at the previous year-end probably is in the neighborhood of $1,500. In such a circumstance there has been a change in operating conditions and the adoption of the installment method is, in effect, the creation of an accounting basis to meet a situation which did not exist before. If it should be considered an inconsistency for some reason not indicated in the problem, the same type of qualification as proposed in Case 1 would be appropriate.

Case 3 does not involve an inconsistency. It is a new situation. However, if it is a material item, disclosure of the amortization procedure should be made by footnote or in the statement itself. This could be worded somewhat as follows: "During the year the company acquired fixed assets at a cost of $00.00, and received a certificate of necessity which permits it to amortize the cost over a period of sixty months for federal income tax purposes. In the opinion of management it is uncertain whether the company will have a continuing need for the assets after completion of government contracts. Therefore, the cost of the assets is being charged against income over a period of five years." If the plant and equipment probably has a life in excess of the amortization period, depreciation for financial statement purposes should be based on the expected life. If the difference in normal depreciation and amortization is material in amount an exception might be required but this would not be based on lack of consistency. Rather it would be based on the unacceptability of the principle followed.

Case 4 is neither a change in principle nor an inconsistency. Basic conditions have changed and there no longer is a subsidiary to be consolidated. Yet there is a problem of lack of comparability in the balance sheet of this year and last year, and the reader's attention should be specifically directed to the difference if the subsidiary was a material factor in the consolidation. One method sometimes followed is to restate the accounts of the prior year without inclusion of the subsidiary along with an explanation of the sale of the controlling interest.

Solution 5

a. Audit program to be performed during preliminary work:

1. Compare the payroll totals from period to period; select three payrolls showing the largest increases and perform the following operations on each payroll:
   (a) Prove footings of all columns of the payroll and cross-foot the totals of the columns.
   (b) Prove correctness of hours worked by reference to clock cards or other underlying data for 10% of the employees.
   (c) Test-check 25% of the pay rates used by reference to copy of union contract.
   (d) Check computation of gross earnings, withholding tax and social security tax for 10% of the employees.
   (e) Examine personnel files for approximately 25% of the employees, checking authorizations for payroll deductions and, in the case of new employees, authorization for addition to payroll.
   (f) Inspect, particularly as to endorsements, cancelled checks for 10% of the wage payments and compare checks with the payroll.
   (g) Check payroll totals to the general ledger accounts and trace net amount of payroll to cash disbursements records.
2. If practicable, be present, without advance notice to the client's employees, on some pay day and observe the delivery procedure; immediately thereafter audit the payroll and account for any unclaimed wages.

b. Audit work to be performed during "final work":

1. Complete the comparison of payroll totals from period to period for the year. Investigate and satisfy yourself as to the propriety of any unusual changes.
2. Reconcile payroll totals for the year with amounts shown on social security records and returns.

Solution 6

Steps related to the engines:

1. Inquire of shop personnel what became of engines and to whom scrap was sold.
2. Report situation to president and suggest that the purchasers be interviewed. In a comparatively small community such as this it would probably cause less speculation if the interviews were conducted by the president. He could say that the auditors were asking for more assistance in support of the transactions in question.
3. If purchasers paid by check, ask to see their cancelled checks. Examine endorsements. Get photostatic copies (both sides), if possible.
4. Inspect any other records junk dealer may have that relate to purchases from the company.

Steps beyond those related to the engines:

5. Extend scope of regular audit procedures on regular cash transactions.
6. Circularize insurance companies and search for unrecorded refunds to company.
7. Circularize oil company from whom fuel is purchased and search for unrecorded quantity rebates.
8. If bus company rents its tires, circularize tire company and search for unrecorded refunds.
9. Extend scope of regular audit of advertising income and search for any receipts that have not been recorded.
10. Report all findings to the president.

Solution 7

The investigation would be started by outlining the procedures followed in the purchasing department as a guide to the procedures to be investigated. Obtain samples of all forms used in connection with the purchasing functions. Review the flow of paper work between purchasing, accounting, receiving, stores and shipping in order to determine that the purchasing department is operating independently of these other departments.

The most important part of the work is the investigation of the actual procedures. First, select a representative number of purchase orders in numerical sequence, and carry out the following steps as to all of them:

(a) Account for all purchase orders in the sequence as either open, closed or voided. Examine all voided copies.
(b) Check each purchase order to see that it is properly prepared and approved.
(c) Examine the relevant purchase requisition or stores requisition card and check for proper preparation and approvals.
(d) Examine the evidence to support the fact that bids and quotations have been solicited before items subject to competitive bidding were purchased.

(e) Discuss with the buyer each case where no evidence of bid solicitation exists to determine that the company is securing materials at the lowest possible costs and not favoring certain vendors due to kickbacks, gifts, entertainment, etc.

(f) Trace purchase orders to an approved vendors list—if there is one. In this connection be on the watch for purchase orders issued to individual employees or their relatives. If the vendor appears to be questionable, examine the cancelled checks issued for payment of the invoices and note in particular the endorsements. Check also to determine what information is available about the vendor in question.

(g) In connection with the review of purchase orders, investigate the circumstances surrounding all purchase orders issued after receipt of merchandise or after receipt of invoice.

(h) Note where change orders have been necessary and see that they have been issued and properly approved.

(i) Investigate any unusual differences with respect to price or quantity.

(j) Investigate any purchases from non-approved vendors.

(k) Observe and test-check the control maintained over the purchase order numbers.

(l) Obtain the vouchers paying for these purchases and compare the purchase orders and the invoices:
    (1) Check quantities and amounts for any differences.
    (2) Check prices, extensions and footings.

Second, observe the incoming-mail handling procedure in the purchasing department for several days. (This should begin on the very first day of the field work to be effective.) Note in particular the handling of:

(a) Refund or rebate checks.
(b) Invoices addressed to buyers or other individuals in the purchasing department.
(c) Any company mail addressed to buyers and marked "Personal" which is delivered unopened.

Third, review the procedure followed in connection with the rejection and return of merchandise to a vendor.

Fourth, review the open purchase order file for old or unusual items and determine that the follow-up procedure is effective.

Fifth, investigate to see that company is buying in economical lots in relation to usage of material. Check to see that purchase orders are not being used for small, insignificant purchases that probably aggregate less than the cost of issuing a purchase order.

Solution 8

1. Observations of the company's procedures to ascertain that they are designed to produce an accurate count:
   a. Review of inventory instructions.
   b. Observations of conformance by local employees.

2. Test of quantities:
   a. Test-counts by the auditor before or during the company inventory. These counts to be traced into the inventory sheets when prepared.
   b. Test-counts from the completed inventory sheets to the stock records.

3. Tests of clerical accuracy:
   a. Scanning of inventory sheets for obvious errors of arithmetic, use of wrong unit (*i.e.,* "each" instead of "dozens"), etc.
   b. Checking of a part of the calculations.
   c. Tracing from original count worksheets to inventory summary (if applicable).

4. Tests of valuation:
   a. Comparison of selling price recorded in the inventory with selling price used on the floor to see that (1) the store manager is not overpricing his inventory or (2) selling stock at higher price than he is charged with.
   b. Comparison of selling prices used with selling prices authorized by head office. Tests to file copies of reports of mark-ups and mark-downs.

5. Test of inventory cut-off:
   This will depend on the bookkeeping system used. Tests would be included to investigate whether the division between pre-inventory and post-inventory receipts were properly reported. Perhaps:
   a. Listing all merchandise received just before and just after the cut-off for later comparison with head office records.
   b. Examination of material set aside in stockroom as new season's business.

6. Inventory quality:
   a. General review of stock to see that conscientious efforts were made to mark down or exclude:
      (1) Shopworn merchandise.
      (2) Out of season—*i.e.,* Christmas merchandise.
      (3) Out of date—magazines, pocket books, "fad" items, etc.
   b. Review of head office instructions in this matter.

7. Auditor's control of results of inventory: Controls against artificial adjustments to inventory after audit tests were made—
   a. Joint mailing of inventory summary to company's auditors; or records of key figures in audit papers.
   b. Transmission of audit papers direct to correspondent auditor accompanied by letter or memorandum of findings.

Commercial Law

May 14, 1954; 9 a.m. to 12:30 p.m.

Solution 1

a. The rule of caveat emptor as to sales of personal property is that the purchaser buys at his own risk unless (1) the seller gives an express warranty or (2) a warranty is implied by law or the circumstances of the case, or (3) the seller is guilty of fraud inducing the sale. (Williston on Sales, Secs. 217, 218, 228; 46 American Jurisprudence, Sales, Sections 337, 341, 346.)

b. The three classifications are (1) sales by description, (2) sales for a particular purpose, and (3) sales by sample. Section 14 of the Uniform Sales Act provides, as to sales by description, that there is an implied warranty that the goods shall correspond with the description, and Subsection 2, Section 15, provides that there is an implied warranty that the goods shall be of merchantable quality. Subsection 1, Section 15 of the Act, provides that where a buyer makes known expressly or by implication to the seller the particular purpose for which the goods are required, and it appears that the buyer relies on the seller's skill or judgment, there is an implied warranty that the goods shall be reasonably fit for such purpose. Section 16 of the Act provides, as to sales by sample, that there is (1) an implied warranty that the bulk shall correspond with the sample in quality, (2) an implied warranty that the buyer shall have a reasonable opportunity of comparing the bulk with the sample (except as provided in Subsection 3, Section 47, of the Act), and (3) an implied warranty, if the seller is a dealer in goods of that kind, that the goods shall be free from any defect rendering them unmerchantable which would not be apparent on reasonable examination of the sample.

c. The unpaid seller's remedies against the buyer under the Uniform Sales Act are (1) a lien on the goods or right to retain them for the price while he is in possession of them; (2) in case of insolvency of the buyer, the right of stopping the goods in transit after he has parted with possession of them; (3) a right of resale if the goods are in the seller's possession and if the goods are of a perishable nature, or if the seller has expressly reserved a right of resale, or if the buyer has been in default in payment of the price for an unreasonable time; (4) a right to rescind the sale if the goods are in the seller's possession and the seller has expressly reserved the right to rescind in case of the buyer's default, or the buyer has been in default for an unreasonable time; (5) an action for the price of the goods; (6) an action for damages for non-acceptance; and (7) where the property in the goods has not passed to the buyer, a right of withholding delivery similar to and coextensive with his rights of lien and stoppage in transit where the property has passed to the buyer. (Subsection 1, Section 53, covers remedies (1) and (2); remedy (3) is covered by Subsection 1, Section 53, and Subsection 1, Section 60; remedy (4) is covered by Subsection 1, Section 53, and Subsection 1, Section 61; Subsection 1, Section 63, covers remedy (5); Subsection 1, Section 64, covers remedy (6); and Subsection 2, Section 53, covers remedy (7).

d. A contract which is divisible (i.e., one the performance of which is divided into different groups, each set embracing performances which are the agreed exchange for each other) may be rescinded in part. An indivisible contract ordinarily may be rescinded only in its entirety although occasionally, as in certain cases of fraud, partial rescission may be essential to a just result. (12 American Jurisprudence, Contracts, Secs. 315, 444, including 1953 Cumulative Supplement; Restatement of Contracts, Sec. 266, Comment e).

Solution 2

a. The objection is not valid. Every negotiable instrument is deemed prima facie to have been issued for a valuable consideration, and every person whose signature appears thereon to have become a party thereto for value. (Sec. 24, Uniform Negotiable Instruments Act.) This presumption places upon the defendant in an action on the instrument the burden of asserting and proving absence or lack of consideration and, if the defendant proves there was no consideration, the plaintiff will be defeated unless he is a holder in due course. (Sec. 28, Uniform Negotiable Instruments Act).

b. The objection is not valid. Though the draft provides for payment in potatoes, it also provides for payment in money.

Subsection 4, Section 5, Uniform Negotiable Instruments Act provides that the negotiable character of an instrument otherwise negotiable is not affected by a provision which gives the holder an election to require something to be done in lieu of payment of money. If the maker or obligor had such an election the instrument would be non-negotiable because of uncertainty as to whether it will be paid in money. But where only the holder has the election, the promise of the maker or obligor to pay in money is unconditional.

c. The objection is not valid. A sum payable is a sum certain even though it is to be paid with interest. (Par. 1, Sec. 2, Uniform Negotiable Instruments Act.) The provision for interest does not render the amount uncertain because the amount due at maturity can be ascertained if the rate of interest is stated in the instrument. If the instrument requires interest but does not state the rate, it bears interest at the legal rate (see Sec. 32 of annotations to Sec. 2, U.N.I.L., in 5 Uniform Laws Annotated, Part 1). Further, Par. 2, Section 17 of the Act provides that where interest is required without specifying the date from which interest is to run, the interest runs from the date of the instrument, or, if the instrument is undated, from the issue thereof.

d. The objection is valid. An instrument is payable to bearer when it is payable to the order of a fictitious person and such fact was known to the person making it so payable. (Par. 3, Sec. 9, Uniform Negotiable Instruments Act). Courts have had difficulty in deciding whether the knowledge of clerks or agents drawing instruments is to be imputed to their employer or principal. The weight of authority is that the knowledge must be that of the person who actually executed the instrument. Here the fact that the payee was fictitious was not known to Miller, who signed the draft, and, therefore, the draft could not be considered payable to bearer; rather, it was order paper which, having been negotiated under a forged indorsement, gave the holder no right to enforce payment against the drawer. (4 *Williston on Contracts, rev. ed.,* pp. 3270-3272 (1936).

e. The objection is not valid. Before acceptance the drawer of a draft is primarily liable since there is then only the implied promise of the drawer to pay in the event the drawee fails to pay and the payee takes proper steps. On acceptance the drawee makes an express promise of absolute payment and becomes primarily liable, and the drawer is then only secondarily liable. Par. 1, Section 143 of the Uniform Negotiable Instruments Act requires that presentment for acceptance must be made in the case of a bill payable after sight, and Section 144 provides that such a bill must be presented by the holder for acceptance or negotiated by him within a reasonable time. Failure to do so discharges the drawer and all indorsers. However, Par. 1, Section 148 of the Act provides that presentment for acceptance is excused and a bill may be treated as dishonored by non-acceptance where the drawee is dead. Since Brown died two days after the draft was drawn, presentment would be excused.

f. The objection is not valid. Section 55 of the Uniform Negotiable Instruments Act provides that the title of a person who negotiates an instrument is defective when he obtained it or any signature thereto by fraud. Section 56 provides that a holder in due course holds the instrument free from any defect in the titles of prior parties, and free from defenses available to prior parties among themselves, and may enforce payment against all parties liable thereon. Clark was a holder in due course and any holder who derives his title through a holder in due course and who is not himself a party to the fraud has all the rights of such holder in due course as against prior parties. (Uniform Negotiable Instruments Act, Sec. 58).

Solution 3

a. No. A contract for the sale of an interest in real property must be in writing under the Statute of Frauds. A partial payment of the purchase price does not satisfy this requirement. (2 *Williston on Contracts, rev. ed.,* pp. 1432-1433.)

b. Yes. The Statute of Frauds requires a note or memorandum in writing, signed by the party to be charged, which note outlines the terms of the contract. This writing may be made at any time before the action to enforce the contract is brought. The party to be charged is the defendant in the action to enforce the contract. In this case the defendant was A. Therefore, the contract is enforceable. (Restatement of Law of Contracts, Secs. 207, 209 and 214, Vol. 1.)

c. No. The Statute of Frauds does not apply to fully executed contracts even if such contract, while executory, requires written evidence to be enforceable. (Restatement of Law of Contracts, Sec. 219, Vol. 1.)

Solution 4

a. Yes. Generally, a traveling salesman has no authority to collect accounts for his principal. The third party, therefore, pays the agent at his peril and remains liable to the principal for the purchase price. (2 American Jurisprudence, Agency, Sec. 126; Restatement of Agency, Sec. 53(c).)

b. Yes. An agent owes a duty to his principal to account for funds of the principal in his possession. The agent owes a duty not to mix funds of the principal with his own; and if the agent does mix funds, any loss must be made good by the agent. (2 American Jurisprudence, Agency, Secs. 282, 284; Restatement of Agency, Sec. 398(b).)

c. Yes. An agent may retain gratuities received on account of the principal's business if, because of custom or otherwise, there is an agreement to this effect. In the absence of an express or implied agreement, the receipt of a gratuity by an agent from a party with interest adverse to those of the principal is evidence that the agent is committing a breach of duty to the principal by not acting in his interest. In the circumstances A would hold the radio as constructive trustee for P and would be required to turn it over to him. (2 American Jurisprudence, Agency, Sec. 268; Restatement of Agency, Secs. 388, 403.)

Solution 5

a. (1) A private carrier is one who agrees in a particular instance only, and not generally, to transport persons or goods for hire, as distinguished from a common carrier who holds himself out to all persons who choose to employ him as ready to carry for hire. (Black's Law Dictionary, 3rd ed., pp. 282-283.)

(2) A private carrier may choose those with whom he wishes to do business, but a common carrier must serve all who apply and is liable in damages for an unjustified refusal to serve the applicant. As to liability for loss of goods, the private carrier, being only an ordinary bailee for hire, is liable only if he is negligent; a common carrier, on the other hand, is ordinarily an insurer and is liable even though not negligent unless the loss results from an "Act of God" or the public enemy, from the act or default of the shipper himself, or from the inherent nature of the property. (9 American Jurisprudence, Carriers, Secs. 285, 286, 661, 705.)

b. (1) An Act of God is an event which is due directly and exclusively to natural causes and is in no sense attributable to human agency. (4 *Williston on Contracts, rev. ed.,* Sec. 1090.)

(2) Public enemies are the forces of a country at war with the country of the carrier. (4 *Williston on Contracts, rev. ed.,* Sec. 1092.)

(3) Deviation is a departure by the carrier from his usual and agreed route. Where the departure is unnecessary or without reasonable excuse, the carrier is absolutely liable for any harm to goods entrusted to its care. (4 *Williston on Contracts, rev. ed.,* Sec. 1079.)

c. A common carrier's lien entitles the carrier to retain goods delivered for carriage to it or to a connecting carrier until freight, storage and, depending upon the jurisdiction, demurrage charges incurred or disbursed by it are paid. It continues as long as the goods are in the carrier's possession and is ordinarily limited to the particular goods for the transport of which the charges are incurred. (9 American Jurisprudence, Carriers, Secs. 636, 638.)

d. Common carriers are not insurers of passengers; that is, they are not liable for injury to passengers unless the injury is occasioned by the carrier's negligence or is wilfully inflicted. A common carrier of passengers must, however, exercise the highest degree of care for the lives and safety of its passengers and hence the degree of negligence which will render the carrier liable for injuries to a passenger is relatively slight. (10 American Jurisprudence, Carriers, Secs. 1236, 1237.)

Solution 6

a. Every partner is an agent of the partnership for the purposes of its business and the execution by any partner of a trading partnership of a negotiable instrument, for apparently carrying on the firm's business, binds the partnership unless the partner had no authority so to act and the person attempting to charge the partnership had knowledge of such lack of authority. (40 American Jurisprudence, Partnership, Secs. 165-166; Uniform Partnership Act, Sec. 9.)

b. Yes. Partners are severally as well as jointly liable for debts of the partnership. (40 American Jurisprudence, Partnership, Sec. 189; see Uniform Partnership Act, Sec. 15(a).)

c. Where a partnership has incurred or will incur liability because of a wrongful act on the part of a partner, the other partners are entitled to have the liability borne entirely by the partner who has acted wrongfully. In this situation Y would have a claim against X for the full amount. However, if X is insolvent, or, not being subject to process, refuses to reimburse Y, the latter would have a right to contribution from Z for one-half of the amount paid. (Mecham, Elements of Partnership, 2nd ed., Sec. 191; Uniform Partnership Act, Secs. 18(a), 40(d).)

Solution 7

a. A property right in unowned objects may be acquired by what is technically known as occupation; that is, by reducing the object to actual possession with the intent to exercise control over it. (Brown on Personal Property, Sec. 8, including Special Note on Possession, p. 18.)

b. The finder of lost property has all the rights of ownership in the property which he has found against everyone except the true owner thereof. (34 American Jurisprudence, Lost Property, Sec. 8.)

c. When accession takes place, the goods of a person are either so changed by the labor of another as to form a new or more valuable piece of property, or else they are so physically united to the property of another as to become a constituent part thereof.

In confusion, however, there is simply an intermingling of the goods of different owners. The goods of each retain their original form and characteristics but, because of the circumstance of intermingling, can no longer be identified, separated and returned to their respective owners. (Brown on Personal Property, Secs. 23, 30; 1 American Jurisprudence, Accession, Sec. 13; 11 American Jurisprudence, Confusion of Goods, Sec. 1.)

Solution 8

a. Yes. Since a debtor incurs no legal detriment by paying part or all of what he owes and a creditor obtains no legal benefit in receiving it, such a payment, if made at the place where the debt is due, in the medium of payment which was due, and at or after maturity of the debt, is not sufficient consideration for any promise. When a debtor pays part of a liquidated debt in return for the creditor's agreement that the debt shall be fully satisfied, such an agreement on the part of the creditor needs for its support other consideration besides the mere part payment. This rule has been changed by decision or statute in a few jurisdictions. However, if the claim is one for an unliquidated amount or if there is a dispute as to whether there is any liability, payment of a lesser amount than the sum claimed will support a promise to discharge the claim. (Williston on Contracts, rev. ed., Vol. 1, pp. 415-416, 437; Restatement of Contracts, Sec. 76(a).)

b. No. If a debtor does something more or different in character from that which he was legally bound to do, this is sufficient consideration for a promise. Accordingly, if a debtor pays his debt or part of it before it is due, the consideration is sufficient to support a promise by the creditor. (Williston on Contracts, rev. ed., Vol. 1, pp. 423-424.)

Solution 9

a. In a bailment for the sole benefit of the bailor, the general rule established in the language of the courts is that the bailee is bound to exercise only slight care; in other words, he is liable only for gross negligence. However, an increasing number of modern authorities hold that "reasonable" care is required of the bailee and that the fact that he is acting gratuitously is merely one factor in the determination of what care is reasonable. (6 American Jurisprudence, Bailments, Secs. 253, 254.)

b. The bailee may seek reimbursement only for necessary extraordinary expenses not resulting from his proper and normal use of the article and not occasioned through his fault. (Elliott on Bailments, 2d ed., Sec. 38.)

c. In a bailment for mutual benefit the bailee must exercise ordinary care and he is liable for ordinary negligence. Ordinary negligence is the failure to exercise that care which a person of ordinary caution and prudence would exercise under the particular circumstances involved. (6 American Jurisprudence, Bailments, Secs. 248, 251.)

d. The agreement between the parties governs. In a situation not covered explicitly by the agreement the purpose of the bailment, as determined by reference to such factors as custom and the nature of the bailed article, determines what uses of the bailed article are legitimate. (6 American Jurisprudence, Bailments, Secs. 172, 187.)

Solution 10

a. 1. The term "employer" for the purposes of the Act does not include any person unless on each of some twenty days during the taxable year, each day being in a different calendar week, the total number of individuals who were employed by him in employment for some portion of the day (whether or not at the same moment of time) was eight or more. (Sec. 1607(a), I.R.C.)

2. Three per cent of the total yearly wages up to $3,000 paid to each affected employee. (Secs. 1600 and 1607(b)(1), I.R.C.)

b. No. The term "employment" under the law does not include "service performed by an individual in the employ of his son, daughter, or spouse, . . ." (Sec. 1426(b) (4), I.R.C.)

c. The term "wages" includes all remuneration with certain exceptions. Dismissal allowances voluntarily made are no longer exceptions under either act. Of the dismissal allowance of $400, $200 constitutes wages under the Federal Employment Tax Act since remuneration, including dismissal payments, up to $3,000 is within the definition of wages (Sec. 1607(b) I.R.C.). The entire $400 constitutes wages under the Federal Insurance Contributions Act since, even with this amount, the total remuneration has not reached the taxable maximum of $3600. (Sec. 1426(a), I.R.C.)

Solution 11

1. False. (29 American Jurisprudence, Insurance, pp. 300-301.)
2. False. (29 American Jurisprudence, Insurance, p. 297.)
3. True. (29 American Jurisprudence, Insurance, p. 318.)
4. False. (29 American Jurisprudence, Insurance, p. 311.)
5. False. (29 American Jurisprudence, Insurance, pp. 148-149, 326.)
6. True. (Vance on Insurance, pp. 177-178.)
7. False. (29 American Jurisprudence, Insurance, p. 401.)
8. False. (29 American Jurisprudence, Insurance, p. 312.)
9. False. (3 Richards on Insurance, 5th ed., Sec. 543.)
10. True. (29 American Jurisprudence, Insurance, p. 950.)

Theory of Accounts

May 14, 1954; 1:30 to 5 p.m.

Solution 1

Arguments in favor of the procedure of the Atgar Corporation are:

1. The net cash price is all that is "surrendered" by the company in exchange for the goods and, therefore, is the real cost of the purchases.

2. The net amount is a better measure of the liability for balance-sheet purposes if the corporation has a good cash position and normally pays within the discount period.

3. The income statement shows only income and does not treat a cost saving (cash discount on purchases) as income. You cannot "make a profit" by buying goods!

4. The cost of lost discounts is clearly shown and administrative control is made easier.

5. In the usual instance there will be only four identical figures which show the net amount payable to be recorded. If the gross amount is entered there will be a figure for it, another for the discount and a third for the net amount paid. Five figures will be used and the chance of error is increased.

Arguments against the procedure are principally those of expediency:

1. The gross amount is always shown on the order, and on the supplier's invoice, but the discounted amount is rarely shown. It is easier to record the invoice as rendered.

2. The gross amount of the invoice is much more likely to be a round amount than is the discounted amount. This is of practical importance in determining unit costs under several methods of keeping inventory records.

3. Confirmations are usually based on gross amounts.

4. No *material* difference in the financial statements will result from recording the gross invoice amounts in most instances. The differences from one year-end to another are unlikely to be significant. Therefore, the easiest method may be used.

Solution 2

The straight-line method of computing depreciation assumes that depreciation is a function of time rather than of activity. Therefore the rate of activity is not ordinarily considered. If the company is consistently to adhere to their method they must take the full depreciation on the old plant. Having adopted the straight-line method, a change to a method based on activity would create a change in principle.

The usual depreciation rate is a composite of several elements such as obsolescence, wear and aging. Some of these elements are related to time, and so depreciation cannot be said to cease entirely when activity is stopped. While there may be some basis for their contention that the machinery is not wearing out, deterioration of a building is probably more a function of time than of use.

The company is correct in arguing that depreciation increases their costs but cost cannot be reduced by ignoring it. They do have a plant which is depreciating and their method of accounting provides for recognizing such cost. However, this depreciation need not go through the inventory account and overvalue it. Depreciation on idle plant should be excluded from manufacturing overhead if it is a significant amount. Neither do they necessarily need to consider it (or, for that matter, various other costs) when setting prices in a competitive market.

The charge for depreciation in any event should be continued for tax purposes because the tax basis of the property will be reduced for allowable depreciation whether or not such depreciation is deducted by the taxpayer.

Solution 3

The deliberate understatement of assets and overstatement of liabilities under the guise of conservatism is not acceptable accounting. It would result in understatement of financial position. Perhaps more serious would be the distortion of income as between years. The acceptable limit of conservatism permits only the choice of the lower of reasonable estimates in cases of uncertainty. It does not justify the use of amounts which are below a reasonable estimate of value for inventory, for instance, nor does it permit following arbitrary policies aimed at preventing payment of dividends through understating earnings.

The dividend policy of a company is a financial-management matter and accounting principles do not prohibit a company's following as conservative a policy as they desire in paying dividends. It may be desirable for the company to maintain a strong position by restricting dividend payments, but that is a decision which should be made in the light of many factors including a fair presentation of financial position and income. While the undervaluation of assets does not lose any assets for the company it does violate management's obligation to report honestly and fairly to stockholders. Payment of dividends may weaken a company in some circumstances, but accounting methods should not be distorted because of that possibility.

The use of accounting to smooth out cycles in business by cutting down the peaks of prosperous years and filling up the valleys of depression years is unacceptable. The creation in good years of undisclosed "reserves" which can be utilized in poor years cannot be supported. While future prospects may have some legitimate bearing on certain estimates, such as the provision for loss on accounts, generally guesses as to distant future prospects must be reflected in management policies rather than in accounting policies. The desire of management to provide against future poor prospects can be accomplished by a careful policy of financing, purchasing, plant expansion, etc., but not by misstating current income or financial position.

Solution 4

The period of sixty months for amortizing, for federal income tax purposes, that portion of emergency facilities covered by Certificates of Necessity may or may not correspond with the estimated useful life of the facilities, which is the generally accepted period over which the cost should be distributed for determining the income reported to stockholders.

The decision to allow the short amortization period for tax purposes may have been reached in order to encourage the construction by private interests of facilities which they might not build without this incentive, and to provide some alternative, acceptable to business men, to direct federal financing of the facilities.

The issuance of Bulletin No. 42 was necessary to point out to business men and accountants that considerations may have entered into the issuance of Certificates of Necessity, with the consequent short period of amortization of cost for tax purposes, which are extraneous to a determination of the proper amortization or depreciation for purposes of reporting income to stockholders.

The principal recommendation of Bulletin No. 42 had to do with situations in which the estimated useful life of the "emergency facilities" was judged to be different from the sixty-month amortization period. In such cases, the Bulletin recommended that only normal depreciation be reported in the income statement and that an amount equal to the reduction (or increase) in the federal income tax occasioned by the difference be charged (or credited) in the income statement for the period. The offsetting amounts would be carried forward in the balance sheet and returned to the income statement when the position as between emergency amortization and normal depreciation is reversed.

The recommendation of the bulletin, as described above, is sound for reasons already intimated. Considerations may have entered into determination of the sixty-month period of emergency amortization which have no place in the theory of periodic accounting of income to stockholders. Since the effect of the emergency amortization upon tax provisions, and therefore net income, may be material, and to the extent that it is, proper accounting of income to stockholders requires that appropriate conventions be developed to make the necessary adjustment to income. The bulletin set out a proposed method for treating these questions.

Solution 5

a. Cash	$24,000	
Investment in Company B stock		$16,000
Dividend income		8,000

To record the company's share of $10,000 profit of Company B since acquisition of stock and to adjust the investment account for a return of investment based on the dividend paid by the subsidiary.

b. The original entry treats the $24,000 dividend as a material extraordinary item. Dividends should be recognized by the parent as income to the extent of profits earned by the subsidiary and accruing to the parent since date of acquisition.

By payment of $24,000 Company B is actually turning over to Company A a part of the assets purchased by Company A, or in other words returning part of A's investment. $16,000 of this dividend, therefore, cannot be considered income but should be treated as a reduction of investment by Company A.

c. Since this is a temporary investment the entire dividend received would be considered as income. In the case of marketable temporary investments, the cost or market rule may be applied. Immediately after payment of a dividend the market price of a stock presumably drops by the amount of the dividend. If there is such a drop which is not offset by price appreciation at balance sheet date, a write-down to market would adjust for the dividends received which were not earned during the holding period. For a number of important practical reasons, no attempt is made to adjust marketable temporary investments for dividends received.

Solution 6

a. 1. Accounting principles do not deal with the question directly. Under accepted accounting principles the amount of retained earnings is presumed to be available for dividends unless there is some contractual or statutory restriction. One of the reasons that accounting insists on the separation of retained earnings from stockholders' contributions, etc., is to indicate the amount available for dividends. Restrictions on the payment of dividends from retained earnings are disclosed. Therefore a contention that only current earnings are available for dividends is not well founded.

2. The same argument as presented in (1) is applicable to a dividend on common. Retained earnings are available for such a dividend in the absence of contractual or statutory restrictions.

b. It is generally agreed that such "excess" is in the nature of a capital contribution by stockholders and as such must go into Paid-in surplus. The Institute's Committee on Accounting Procedure takes the position that, while the net asset value of the shares of common stock outstanding in the hands of the public may be increased or decreased by purchase and retirement of stock, such transactions relate to permanent capital. They conclude that there is no essential difference between the purchase and retirement of stock and the subsequent sale of a new issue, and the purchase and resale of the same stock.

Solution 7

Costs of completed research projects can be capitalized, charged to manufacturing expense or overhead of a specific product, or charged directly to profit and loss. Costs of research projects which are incomplete can be deferred until completion, charged to production, or charged directly to profit and loss.

If capitalized, research costs can appear in the balance sheet under Patents, Tools and Dies, Deferred Charges or similar captions. If charged to production, research costs will be included in inventories of work in process, finished goods and as part of cost of goods sold. If charged directly to profit and loss, research costs can be included under Selling expenses, under General and Administrative expenses or under a separate caption for research expenses. If shown under a separate caption they can be shown in either the operating or non-operating section of the income statement.

For the Plastic Products Company consideration must be given to the purpose of the research; whether the research is recurring or special; whether it is successful or unsuccessful. Consideration must be given to the uncertainties involved and to the accounting doctrines of consistency and conservatism. Practices of other companies in the industry may be given weight.

As a general principle costs of unsuccessful research should not be capitalized. The success of projects which are incomplete at the balance-sheet date may be uncertain, and it is a matter for considered judgment as to whether the costs of incomplete projects are deferred until completion of the research.

The charge-off of recurring and continuous research costs may be justified by analogy to the treatment of advertising costs. Both may be necessary to maintain the present competitive position of the business, and any future benefit may be uncertain and unmeasurable.

On the other hand, special research for the development of new products may be capitalized along with other development costs. Uncertainty as to the creation of an asset, as to the amount of cost attributable to the asset and as to the value of the asset may, however, indicate that it is unwise to capitalize.

Research for the improvement of manufacturing methods may be a product cost. If capitalized, it appropriately could be written off to product overhead rather than to general manufacturing overhead. Research to improve the appearance of a product may be primarily for sales purposes and, therefore, could be shown as a selling expense on the income statement.

The difficulty of determining the nature, purpose and cost of individual research projects may dictate the treatment of all research costs as a unit. They then may be charged off to general factory overhead or shown as a separate item on the income statement. The latter treatment has the advantage of disclosing the full amount of research costs for the period.

Solution 8

The word "reserve," except when it relates to appropriated retained earnings, should be deleted from the balance sheet and other more descriptive terms used because the term has so many different and conflicting meanings as to make its use unwise in financial statements.

Change "reserve for bad debts" to "allowance for uncollectible accounts."

Reclassify "prepaid expenses" to "current assets" in accordance with current AIA bulletin.

Change "reserve for depreciation" to "accumulated depreciation."

Change "reserve for income taxes" to "income taxes payable."

Change "reserve for damages" to "damages payable" and reclassify to "current liabilities" because it is an actual liability which probably will be paid during the current year.

Change "capital surplus" to "capital contributed in excess of par value of capital stock" to show the source of the additional capital.

Change "earned surplus" to a term such as "retained earnings" to indicate the source and to describe the item better.

Reclassify the "reserves for possible future inventory losses" and for "contingencies" as "appropriations of retained earnings" and show them as subdivisions of that item in the capital section of the balance sheet in order to show their nature more clearly.

Change "reserve for additional federal income taxes" to "estimated liability for additional federal income taxes" and reclassify as a "current liability" to show its true nature.

Solution 9

a. Except for adjustments which might result from a revenue agent's review, the tax recoverable under the carry-back provisions of the tax law is $7,500, the amount applicable to the year 1952, paid in 1953.

At December 31, 1953, the reserve for income taxes on uncollected installment notes would amount to $104,000 (gross profit of $200,000 at 52 per cent). The unapplied loss to be carried forward would amount to $285,000, determined as follows:

Book loss	$290,000
Add—Increase in income deferred for tax purposes	20,000
Tax loss	$310,000
Deduct—Taxable net income for 1952	25,000
Loss carry-forward	$285,000

b. Inasmuch as the available loss carry-forward ($285,000) exceeds the income deferred for tax purposes ($220,000) at December 31, 1953, a credit of $104,000 (in addition to the tax refund claimed) should be included in the 1953 statement of income. This amount is equal to the amount which would no longer be required in the tax reserve for uncollected installment notes because of the 1953 operating loss in the same way as if it were to have been recovered under the carry-back provision of the tax law.

c. Since the future need for this reserve was eliminated by reason of the loss developed in 1953, the credit of $104,000 should be included in the income account for that year, thereby relating it to the period which produced the loss.

In the future, as the company makes a taxable profit, the income account will include a charge for income taxes based upon the book income after recovery of the 1953 loss. Until the 1953 tax loss is absorbed, the company will pay no taxes within the five-year carry-forward limitation. The provisions for income taxes made during this period will be added to the reserve for tax on uncollected installments until it is reinstated to the 52 per cent level of deferred gross profit, assuming a constant tax rate of 52 per cent. Thus it is believed that the income account for 1953 will reflect the correct net result of operations after taxes, and the income accounts in future years will also be correctly stated.

Answers to Examinations, November, 1954

Accounting Practice Part I

November 3, 1954, 1:30 to 6 p.m.

Solution 1

a. **BLOOM FLORIST SHOPS**

Income Statement Worksheet, Year Ended July 31, 1954

	Income Statement Per Client	Adjustments Debit	Adjustments Credit	Adjusted Income Statement
Receipts:				
Cash sales	$100,000			$100,000
Charge sales	120,000	$120,000(1)		
Inbound FTD orders received	25,000	25,000(3)		
20% of outbound FTD orders sent	3,000	3,000(5)		
Miscellaneous*	2,000	600(11)	$ 200(8)	1,600
Cash received on account			115,000(2)	115,000
Cash received from FTD			7,500(6)	7,500
Total receipts	$250,000	$148,600	$122,700	$224,100
Expenses:				
Purchases, flowers	$ 80,000			$ 80,000
Purchases, other merchandise	5,000			5,000
Salaries and wages	75,000			75,000
Rent	7,200			7,200
Express and freight*	7,000			7,000
Utilities	2,000			2,000
Telephone and telegraph	3,000			3,000
Delivery expense and repairs	5,500		$ 600(11)	4,900
Repairs and maintenance	3,000			3,000
Advertising	2,500		1,500(9)	1,000
Discounts and refunds	2,000			2,000
Depreciation and amortization†	2,500	$ 50(10)		2,550
FTD discount on orders received	5,000		5,000(4)	
Payments to FTD	4,000			4,000
Interest	1,500			1,500
Miscellaneous	4,000		500(7) 200(8)	3,300
Total expenses	$209,200	$ 50	$ 7,800	$201,450
Net Profit	$ 40,800	$148,650	$130,500	$ 22,650

* Refunds might be reclassified as an offset to freight expense, reducing each amount by $200.00.

† No adjustment of depreciation is required if it is assumed that client takes depreciation on end-of-month balances.

b. **Explanations of Adjustments**

(1) Debit $120,000	To eliminate charge sales from cash basis income statement.
(2) Credit $115,000	To include cash received on accounts receivable in cash basis income statement.
(3) Debit $ 25,000	To eliminate FTD orders received. FTD transactions should be recorded on a cash basis.
(4) Credit $ 5,000	To eliminate FTD discount on orders received. FTD transactions should be recorded on a cash basis.
(5) Debit $ 3,000	To eliminate 20% of outbound FTD orders sent. This income is already included in cash received in cash sales and cash received on account.
(6) Credit $ 7,500	To record cash received from FTD in various monthly settlements.
(7) Credit $ 500	To eliminate bad account write-off which is not a proper item for a cash basis statement.
(8) Credit $ 200 Credit $ 200	To eliminate cash over from miscellaneous expenses and include it in miscellaneous receipts.
(9) Credit $ 1,500	To eliminate FTD advertising and expense since these items are included in the net settlements reported by inclusion of cash payments to and cash receipts from FTD.
(10) Debit $ 50	To adjust depreciation taken as follows:

Total cost of vehicle purchased	$3,200
Attributable to business (75%)	2,400
Depreciation—4-year basis ½ yr.	300
Depreciation formerly included	250
Adjustment (Debit)	$ 50

The gross cost of the vehicle is used because the trade-in was not a business asset.

(Optional)

(11) Transfer $ 600 — To transfer reimbursement for truck repairs to offset expense incurred.

c.

Several important advantages would be gained by Mr. Bloom in the installation of a formal set of records:

1. He would acquire a systematic method of recording the financial transactions of the business. Accounting—the Language of Business—must be employed, using all its basic techniques if it is to speak fully. In the problem, the necessity of periodically preparing large worksheets would be eliminated and the interim determination of income figures would be simplified.

2. Mr. Bloom would have available a balance sheet, showing the status of the business at any time the accounts are closed. Without an organized set of records, such a statement is at best a hazardous guess. This is not strongly illustrated in the problem, but acquaintance with balance-sheet concepts and the corresponding emphasis of the separation between business and personal assets would have prevented an error such as that involving the auto depreciation.

3. The opportunity for some of the income statement errors occurring would be eliminated. Such errors are costly not only from the standpoint of misinformation but in the excess taxes paid on income so reported. Examples of these errors are:

(a) The inclusion of FTD receipts twice in income in the case of the 20% of the outbound orders.

(b) The inclusion in the income statement of inbound FTD orders without being offset by the outbound FTD, if carried through on accounts, would quickly show an error in that the amount apparently due from FTD would be much larger than is actually due.

(c) Inclusion of "cash over" as an expense could not occur.

4. A formal, self-balancing system of record-keeping is susceptible to several independent checks, not only by auditors, but by management. For example, the following data can be checked against outside sources: Cash (bank statements and audit confirmations), payables (creditors' invoices, statements and audit confirmations) and receivables (audit confirmations).

5. Good records not only aid the business internally through such organization and presentation of the facts, but are valuable aids and acceptable sources of information in dealings with outside organizations such as banks, insurance companies and the Internal Revenue Service.

6. Use of a formal system might encourage a better understanding of accounting principles on the part of Mr. Bloom, particularly in the interpretation and use of data presented in the financial statements. (The ground is prepared for such encouragement in that Mr. Bloom has been alarmed by the discrepancy between apparent "profits" and the lack of improvement in financial position.)

Also, the need to hire a bookkeeper with at least some training in fundamental accounting principles should reduce the occasion for such errors as the inclusion of non-cash items in a cash-basis statement (for example, the bad debt write-off in this problem).

7. Subsequent audits can be less detailed and, accordingly, less costly.

Solution 2 *a.*

WILLIAM BOYCE
Analysis of Transactions in Ives Corporation Common Shares
June 12, 1947 to March 31, 1954

Date	Transaction	Block 1 Shares	Block 1 Amount	Block 2 Shares	Block 2 Amount	Block 3 Shares	Block 3 Amount	Block 4 Shares	Block 4 Amount	Block 5 Shares	Block 5 Amount
6/12/47	Purchased (par $100)	50	$4,600.00								
12/15/47	Paid assessment	—	250.00								
4/15/50	Converted 50 shares of Ives preferred			50	$5,050.00						
11/ 2/51	Received $.50/share, cash dividend										
5/ 7/52	Received additional shares (Par reduced to $50) (2-for-1 stock split)	50	—	50	—						
6/ 2/52	Purchased					100	$5,300.00				
11/ 4/52	Exercised option to receive 1 share stock dividend for each 10 shares held, in lieu of $5.40/share (FMV $54/share)							30	$1,620.00		
11/ 2/53	Received ordinary stock dividend —20%	20	—	20	—	20	—	6	—		
1/ 4/54	Received warrants representing right to purchase at par 1 share of common for each 10 shares held. (*Note:* At this point costs could be apportioned between shares and rights for each block or, as in this solution, the apportionment can be deferred until disposal of rights takes place.)										
1/15/54	Exercised 100 rights. (See computation)					—	(147.23)			10	$647.23
	Sold remaining 296 rights. (See computation)	—	(161.67)	—	(168.33)	—	(29.44)	—	(54.00)		
3/12/54	Sold. (See computation)					(50)	(2,134.72)			(10)	(647.23)
3/31/54	Balance	120	$4,688.33	120	$4,881.67	70	$2,988.61	36	$1,566.00	—	$ —

b. Total dividend income reportable

		Tax Return	Statements
11 /2/51	Cash dividend	$ 50.00	$ 50.00
11/ 4/52	Value of stock received in lieu of cash dividend	$1,620.00	$1,620.00
		$1,670.00	$1,670.00

c. Gain reportable*

		Tax Return	Statements
1/15/54	Gain on sale of 296 rights (see computation)	$124.36	$119.36
3/12/54	Gain on sale of 60 shares (see computation)	458.05	458.05
		$582.41	$577.41

* A gain of $150 would be included in the statements as a result of the conversion on 4/15/50.

Supporting Computations

Apportionment of Cost Between Shares and Rights

	Block 1	Block 2	Block 3	Block 4
Shares held at 1/4/54	120	120	120	36
Cost accumulated to 1/4/54	$4,850.00	$5,050.00	$5,300.00	$1,620.00
Market value of stock/share, ex-rights	58.00	58.00	58.00	58.00
Market value of a right	2.00	2.00	2.00	2.00
Shares: 58/60 × cost	$4,688.33	$4,881.67	$5,123.33	$1,566.00
Rights: 2/60 × cost	161.67	168.33	176.67	54.00
Total Cost	$4,850.00	$5,050.00	$5,300.00	$1,620.00

Cost of Block 5 Shares

Apportioned cost of rights exercised:	
100/120 × $176.67	$ 147.23
Cash price of 10 shares	500.00
	$ 647.23

Gain on Sale of 296 Rights

	Statements		Tax Return	
Net proceeds		$532.80		$532.80
Less—apportioned cost of rights sold:				
Block 1	$161.67		$161.67	
2	168.33		168.33	
3	29.44		29.44	
4	54.00	413.44	54.00	408.44
		$119.36		$124.36

Gain on Sale of 60 Shares

Net proceeds		$3,240.00
Block 3 cost:		
Cost/share ($5,123.33 ÷ by 120 shares) = $42.6944		
$42.6944 × 50 shares =	$2,134.72	
Block 5 cost (10 shares)	647.23	$2,781.95
Gain		$ 458.05

Solution 3

A.B.C. LUMBER COMPANY

a. **Computation of Capital Gain on Timber Cut in 1954**

Cost of land and timber—15,000 acres	$240,000.00
Amount assignable to land at $3 per acre	45,000.00
Cost of timber	$195,000.00
Value per M ft. (30,000 M ft.)	$ 6.50

Timber cut during 1954 (M ft.):	Pine	Gum	Total
Lumber	3,000	500	3,500
Logs on hand	50	10	60
Total cut	3,050	510	3,560
Fair market value 1/1/54, per M	$ 45	$ 30	
Fair market value	$137,250	$15,300	$152,550
Depletion on cost @ $6.50 per M			23,140
Capital gain			$129,410

b. **Valuation of Inventories—12/31/54**

Manufactured lumber:	For Statements	For Taxes
Depletion—pine (1,000 M)	$ 6,500	$ 45,000
Depletion—gum (200 M)	1,300	6,000
Cutting and logging (1,200 M @ $20)	24,000	24,000
Manufacturing (1,200 M @ $18)	21,600	21,600
Total lumber	$53,400	$ 96,600
Logs:		
Depletion—pine (50 M)	$ 325	$ 2,250
Depletion—gum (10 M)	65	300
Cutting and logging (60 M @ $20)	1,200	1,200
Total logs	$ 1,590	$ 3,750
Total inventories	$54,990	$100,350

c.

Discussion:

The company is on the lower of cost or market basis. However, the exact market value is not known, but in view of the low depletion charge in relation to fair market value of standing timber, it is reasonable to assume that cost for balance-sheet purposes is considerably lower than market.

For tax purposes, it has been assumed that cost as determined is lower than market in the absence of exact fair market values for lumber and logs at 12/31/54. The lower fair market values of standing timber at 12/31/54 do not necessarily mean that fair market values of logs and finished lumber will be lower than "cost" as determined by the provisions of the law.

In preparing the federal income tax return, net income per return will be greater than net income per books to the extent of the higher inventory values used for tax purposes. This is an instance where valuation of inventories for tax purposes is different from the valuation in accordance with generally accepted accounting principles. Accordingly, in preparing the balance sheet, these principles must be adhered to, while in the preparation of the tax return, the provisions of the income tax law must be followed. A Schedule M adjustment will be required on the return to reconcile tax treatment with generally accepted accounting treatment.

The assignment of depletion (on cost) to the pine and gum on an equal basis in spite of the relative differences in value of the timber, would be questionable procedure if it were actually done by the company except that the amount is relatively small in relation to market value. Also, unless the company re-estimates each year, it will likely have standing timber after all cost has been written off due to normal growth of the timber.

Solution 4

COMPANY B AND SUBSIDIARY COMPANY
Consolidating Balance Sheet as at December 31, 1953

	Company A	Company B	Eliminations	Consolidated
Cash and investments	$ 50,000	$ 7,000,000	($1,800,000)	$ 5,250,000
Receivables, less reserves	300,000	2,400,000		2,700,000
Inventories	1,600,000	11,200,000		12,800,000
Prepayments	47,000	422,000		469,000
Total Current Assets	1,997,000	21,022,000	(1,800,000)	21,219,000
Fixed assets, less reserves	2,003,000	18,978,000		20,981,000
Excess of cost of investment in B over book value at date of acquisition (Note)			720,000	720,000
	$4,000,000	$40,000,000	($1,080,000)	$42,920,000
Payables	$1,750,000	$ 7,872,000		$ 9,622,000
Accruals	450,000	1,615,000		2,065,000
Total Current Liabilities	$2,200,000	$ 9,487,000		$11,687,000
Minority interest in Company A:				
Common stock			$ 400,000	400,000
Retained earnings			320,000	320,000
Common stock				
Company A 10,000 shares	1,000,000		(1,000,000)	
Company B 100,000 shares		10,000,000		10,000,000
Retained earnings	800,000	20,513,000	(800,000)	20,513,000
	$4,000,000	$40,000,000	($1,080,000)	$42,920,000

Note: At date of acquisition of the stock of B, an appraisal of the fixed assets of B showed an amount which was $1,200,000 in excess of the amount shown by the books. The purchase of the stock of B was made at a price which reflected this higher valuation.

Comment: Under the circumstances it might be appropriate to adjust the fixed assets of B upward by the full $1,200,000 and to assign $480,000 of the adjustment to the minority interest in B as a surplus created by write-up. This would be adhering to the theory that the price of the stock can be used to determine the value of the minority or, in effect, that a consolidated entity should show consistent values.

Solution 5

H. G. COMPANY

a. **Computation of Variance for September**

	Labor	Overhead
September production—2,080 units:		
Actual cost	$49,947.20	$68,365.00
Standard cost	49,920.00	64,896.00
Variance over standard	$ 27.20	$ 3,469.00

b. **Analysis of Variance**

Direct Labor—2,080 Units

	Actual	Standard	Over or (Under)
Labor hours	32,860	33,280	(420)
Labor rate	$1.52	$1.50	$ .02
Variance due to rate: $.02 × 33,280			$ 665.60
Variance due to hours: (420) × $1.50			(630.00)
Variance due to rate and hours: (420) × $.02			(8.40)
Net variance as above			$ 27.20

Overhead

	Actual	Standard	Over or (Under)	Applied (130% of Labor)	Amount Unapplied
Fixed (55% of labor)	$29,300	$27,456	$1,844	$27,470.96	$1,829.04
Variable (75% of labor)	39,065	37,440	1,625	37,460.40	1,604.60
Total	$68,365	$64,896	$3,469	$64,931.36	$3,433.64

Causes of Variance

Fixed (55% of direct labor cost):	
Overspending: $29,300 actual, less $29,040 budget	$ 260.00
Difference in number of days of production:	
2 days at 100 per day = 200 units short	
200 units at 55% of standard labor of $24	2,640.00
Excess of production over expected per day—	
80 units at 55% of standard labor of $24	(1,056.00)
Net excess of actual over standard	$ 1,844.00
Overapplication as a result of direct labor cost variation (55% of each variance)	14.96
Net amount underapplied	$ 1,829.04
Variable (75% of direct labor cost):	
Units underexpected (2,200 — 2,080) = 120	
120 units at $18 (75% of $24 direct labor)	$ 2,160.00
Amount spent under budget ($39,600 — $39,065)	(535.00)
Net amount over standard	$ 1,625.00
Overapplication as a result of direct labor cost variation (75% of each variance)	20.40
Net amount underapplied	$ 1,604.60

Accounting Practice—Part II

November 4, 1954; 1:30 to 6 p.m.

Solution 1

a. **SELLER'S ENTRY (ADAMS)**

Mortgage payable	$ 73,458.01	
Cash	54,072.73	
Accumulated depreciation—buildings	32,500.00	
Lease deposits	850.00	
Rental income	327.50	
Property tax expense	200.00	
Interest expense	185.13	
Gain on sale of fixed assets		$85,165.00
Buildings		75,000.00
Insurance expense (or prepaid)		1,428.37

To record sale to Baker, on February 28, 1954, for $135,000 sale price, of apartment house acquired June, 1937. (Escrow #32049, Fidelity Title and Insurance Co.)

b. **BUYER'S ENTRY (BAKER)**

Buildings	$135,439.50	
Prepaid insurance (or expense)	1,428.37	
Due from Fidelity Title and Insurance Co.	2.77	
Mortgage payable		$73,458.01
Cash on deposit with escrow agent		61,850.00
Lease deposits payable		850.00
Rental income (or unearned)		327.50
Property taxes payable (or expense)		200.00
Accrued interest payable (or expense)		185.13

To record purchase from Adams, on February 28, 1954, for $135,000 sales price, of apartment house. (Escrow #32049, Fidelity Title and Insurance Co.)

c. **COMPUTATION OF GAIN**
(For Federal Income Tax Purposes)

Sale price*			$135,000
Cost, June, 1937	$75,000		
Less depreciation to February 28, 1954	32,500	$42,500	
Expenses of sale:			
Commission	$ 6,750		
Escrow fees and revenue stamps	585	7,335	49,835
Gain on sale			$ 85,165

* The above answer (c) is based on the 1954 Internal Revenue Code. Under prior law, the entire amount of taxes assessed would be deductible by the seller with the amount of taxes collected from, or payable by, the purchaser added to the selling price. This would have increased the gain by $400 in this instance if the taxing authority has a June 30 tax year (taxes at $100 per month for March 1 through June 30).

Solution 2

Supporting Computations

Item	*Answer*			
1.	b	Reconciliation of book and statement balances—12/31/53:		
2.	a	Balance per bank statement—12/31		$12,301
3.	b	Add cash in transit—12/31		827
4.	d.	Deduct outstanding checks		(6,040)
				$ 7,088
		Balance per check book—12/31		$ 7,040
		Add interest collected on bonds		150
		Deduct: bank charge		(10)
		returned check		(92)
		Corrected balance—12/31		$ 7,088
6.	e	Proceeds of bank loan are included in both balances		
7.	b	Total cash:		
		In bank (per reconciliation)		$ 7,088
		On hand (per 12/31 "inventory")		92
				$ 7,180
8.	b	Accounts receivable—trade (net):		
		Amount per file		$ 7,220
		Returned check		92
		Write-off of 1953 accounts		(310)
		Estimated uncollectible		(402)
				$ 6,600
9.	c	Accrued interest receivable:		
		Accrual 1/1 (bonds $40, note $5)		$ 45
		1953 interest (bonds $480, note $10)		490
		Collected: per check book	$345	
		per bank credit	150	(495)
				$ 40

Item	*Answer*	**Supporting Computations**		
10.	c	Prepaid expenses:		
		Amount per 12/31 inventory		$ 568.00
		Advance to L		720.00
				$ 1,288.00
		Proportionate part (95%) of discount		71.25
				$ 1,359.25
11.	c	Non-current assets:		
		Filo bonds		$ 8,000
		Equipment (net)		2,406
				$10,406
12.	c	Liabilities and capital:		
		Accounts payable		$ 7,943.00
		Bank loan		3,000.00
		Accrued operating expenses		326.00
		Capital:		
		1/1 Balances	$34,669.00	
		Additional investments	5,000.00	
		Net income (computed)	4,793.25	
		Withdrawals	(10,700.00)	33,762.25
				$45,031.25
		Proof:		
		Cash (#7)		7,180.00
		Accounts receivable (net) (#8)		6,600.00
		Accrued interest receivable (#9)		40.00
		Prepaid expenses (#10)		1,359.25
		Inventory		19,446.00
		Non-current assets (#11)		10,406.00
				$45,031.25

* Note: This problem does not require supporting computations. However, to determine the correct answer, computations are necessary. These schedules show a basis for computing each of the answers.

13.	b	Net sales:	
		Accounts receivable (gross)—12/31 (#8)	$ 7,002.00
		Audit write-offs (1953 accounts)	310.00
		Notes receivable—trade—12/31	—
		1952 accounts written off	504.00
		Collection of note ($995 less $15 interest)	980.00
		†Collections on account	205,320.00
		Returned check charged back	(92.00)
		Accounts receivable—(gross)—1/1	(9,465.00)
		Notes receivable—trade—1/1	(980.00)
		Sales	$203,579.00
		†Received from customers	$205,629.00
		Redeposit of "NSF" check (July)	(204.00)
		Collection of account written off	(105.00)
			$205,320.00

Item	*Answer*	**Supporting Computations**		
14.	d	Net purchases:		
		Accounts payable—12/31 balance		$ 7,943
		Payments		113,064
		Accounts payable—1/1 balance		(6,991)
		Purchases on account		$114,016
		Cash purchases		4,640
				$118,656
15.	d	Bad debt expense (net):		
		Write-offs (1952 accounts)		$ 504
		Write-offs (1953 accounts)		310
		Estimated uncollectible—12/31		402
		Collection of 1952 accounts written off		(105)
		Estimated uncollectible—1/1		(380)
				$ 731
16.	b	Operating expenses (excluding bad debts—net):		
		Amount paid		$ 80,120
		Depreciation		124
		Prepaid expenses—12/31 (#10)	$1,288	
		Prepaid expenses—1/1	492	(796)
		Accruals—1/1	$562	
		Accruals—12/31	326	(236)
				$ 79,212
17.	c	Interest income:		
		Accrued—12/31 (#9)		$ 40
		Collected on note		15
		Collected on bonds		480
		Accrued—1/1		(45)
				$ 490
18.	b	Other non-operating revenues and gains:		
		Equipment (net)—12/31		$ 2,406
		Depreciation—1953		124
		Equipment purchased		(500)
		Equipment (net)—1/1		(2,220)
		Book value of equipment sold		$ (190)
		Proceeds of sale		250
		Gain on sale of equipment		$ 60
19.	c	Other expenses:		
		Prepaid interest—1/1		$ 72.00
		Bank discount—1953		75.00
		Prepaid interest—12/31 (#10)		(71.25)
		Interest expense		$ 75.75
		Bank charges ($25 + $10)		35.00
				$ 110.75

Item	*Answer*	**Supporting Computations**			
20.	a	Gross profit:			
		Net sales (#13)			$203,579
		Less cost of sales:			
		Inventory—1/1		$ 20,072	
		Net purchases (#14)		118,656	
		Inventory—12/31		(19,446)	119,282
					$ 84,297
21.	b	K's interest allowance:			
		$14,360 × 3 months			$ 43,080
		17,360 × 5 months			86,800
		19,360 × 4 months			77,440
		12 months			$207,320
		Monthly investment of $207,320 at ½ of 1% = $1,036.60			

			K	*L*	*Total*
22.	d	K's share of assumed profit:			
		Interest allowance	$ 942.00	$ 1,218.54	$ 2,160.54
		Salary allowance	6,000.00	4,000.00	10,000.00
		Overdistribution—equally	(2,080.27)	(2,080.27)	(4,160.54)
		Net income distributed	$ 4,861.73	$ 3,138.27	$ 8,000.00

			K	*L*	*Total*
23.	b	K's share of assumed loss:			
		Interest and salary allowed as above	$ 6,942.00	$ 5,218.54	$12,160.54
		Overdistribution—equally	(6,580.27)	(6,580.27)	(13,160.54)
		Net loss distributed	$ 361.73	($ 1,361.73)	($ 1,000.00)

Solution 3

a. **THE SELLOW FURNITURE CO., INC.**

Statement of Affairs—September 30, 1954

Book Value		*Estimated Value*	*Expected to Realize*
	Assets pledged with fully-secured creditors:		
$201,560	Installment contracts (less allowance for bad contracts)	$175,000	
	Less bank loan	161,250	$ 13,750
10,240	Land		
82,230	Buildings (less allowance for depreciation)	$ 75,000	
	Less first mortgage (plus $490 accrued interest)	49,490	25,510
	Assets pledged with partially-secured creditors:		
7,420	Autos and trucks (less allowance for depreciation), deducted contra	$ 8,000	—
10,360	Furniture and equipment (less allowance for depreciation), deducted contra	5,000	—
	Free assets:		
2,120	Cash	2,120	2,120
19,780	Accounts receivable—30-day (less allowance for bad debts)	16,500	16,500
206,180	Inventories	100,000	100,000
1,490	Unexpired insurance	990	990
880	Organization expense	—	—
	Total expected to be realized		$158,870
	Less—priority claims (contra)		23,900
	Expected to be available for unsecured claims		$134,970
	Estimated deficiency		110,430
$542,260			$245,400

Solution 3—*(continued)*

a. **THE SELLOW FURNITURE CO., INC.**

Statement of Affairs—September 30, 1954

Book Value			*Expected to Rank*
	Liabilities having priority:		
$ 14,220	Taxes payable	$ 14,220	—
—	Estimated administrative costs of liquidation	5,000	—
4,680	Accrued salaries and wages	4,680	—
	Deducted contra	$ 23,900	
	Fully-secured liabilities:		
161,250	Bank loan (deducted contra)		—
49,490	First mortgage (including 2 months' interest at 6% = $490), deducted contra		—
	Partially-secured liabilities:		
10,000	Chattel mortgage	$ 10,000	
	Less autos and trucks pledged (net)—estimated realization (contra)	8,000	$ 2,000
5,800	Contract payable—F & E	$ 5,800	
	Less furniture and equipment, estimated realization (contra)	5,000	800
	Unsecured liabilities not having priority:		
132,100	Trade accounts payable		132,100
110,500	Notes payable to stockholders (not subordinated)—plus accrued interest of $10,500		110,500
	Capital:		
100,000	Capital stock		—
(45,780)	Deficit		—
$542,260			$245,400

b. **THE SELLOW FURNITURE CO., INC.**

Statement of Estimated Deficiency to Unsecured Creditors
September 30, 1954

Estimated shrinkage in value of assets:		
Land and buildings		$ 17,470
Furniture and equipment		5,360
Installment contracts receivable		26,560
Accounts receivable		3,280
Inventories		106,180
Unexpired insurance		500
Organization expense		880
		160,230
Estimated increase in value of assets:		
Autos and trucks		580
Net estimated shrinkage		$159,650
Estimated additional liabilities:		
Estimated cost of administration		5,000
Total estimated loss		$164,650
Capital:		
Capital stock	$100,000	
Surplus (deficit)	(45,780)	54,220
Estimated deficiency to creditors		$110,430

c. Percentage of recovery by general creditors would be 55%. ($134,970 divided by $245,400)

Solution 4

COUNTY COLLEGE

Trial Balance—December 31, 1953

Endowment Funds		
Cash	$ 25,400.00	
Due from annuity funds	—	—
Interest accrued on special investments	—	—
Special investments	30,000.00	
Merged investments	5,000.00	
Reserve for gains and losses on merged investments		$ 400.00
Principal balances		60,000.00
Student Loan Funds		
Cash	930.00	
Loans receivable	200.00	
Fund balance		1,130.00
Current Restricted Funds		
Cash	133.33	
Merged investment income	—	—
Fund balance		133.33
Current General Funds		
Cash	166.67	
Unappropriated surplus		166.67
Annuity Funds		
Cash	—	—
Investments	—	—
Due to endowment funds	—	—
Principal	—	—
Income	—	—
Plant Funds—Unexpended		
Cash	4,000.00	
Investments	150,000.00	
Unexpended balances		154,000.00
Plant Funds—Invested in Plant		
Buildings	250,000.00	
Mortgage payable		47,500.00
Gifts invested in plant		202,500.00
	$465,830.00	$465,830.00

Recording of Transactions*

Item	*Fund*†			
1	EF	Cash	$ 10,000	
		Principal balances		$ 10,000
2	EF	Cash	20,000	
		Principal balances		20,000
3	EF	Cash	30,000	
		Principal balances		30,000
4	AF	Cash	200,000	
		Principal balances		200,000
5	PFU	Investments	150,000	
		Unexpended balances		150,000
6	EF	Merger investments	25,000	
		Cash		25,000
7	EF	Special investments	30,000	
		Interest accrued on special investments	375	
		Cash		30,375
8	AF	Investments	200,000	
		Cash		200,000
9	EF	Cash	375	
		Interest accrued on special investments		375
9	SLF	Cash	375	
		Fund balance		375

* Note: Candidates were required to record the transactions for 1953 in skeleton ledger accounts. However, this solution presents entries in journal form, since it is believed that students may follow the recording of each transaction more readily in such a presentation.

† Fund in which entry is made: AF = Annuity funds; CGF = Current general funds; CRF = Current restricted funds; EF = Endowment funds; PFI = Plant funds—invested in plant; PFU = Plant funds—unexpended; SLF = Student loan funds.

Item	*Fund*			
		Terms of the Green gift specify that interest is to be used for student loans. Of the $750 collected on Steam Power Co. bonds, $375 restores the Endowment funds principal expended for accrued interest upon purchase.		
9	CRF	Cash	500	
		Merged investment income		500
		Six months' interest on Electric Power bonds (Jones and Smith gifts)		
9	CRF	Merged investment income	333.33	
		Fund balance		333.33
		Two-thirds of above $500 interest on merged investments. Terms of Jones gift, which supplied two-thirds of funds for merged investments, restrict use of income.		

Item	Fund			
9	CRF	Merged investment income	166.67	
		Cash		166.67
		One-third of interest on merged investments is transferred to Current general funds. Terms of Smith gift do not restrict use of income.		
9	CGF	Cash	166.67	
		Unappropriated surplus		166.67
		Credit would be to "Estimated income" if this item had been considered in the budget estimate of income.		
9	AF	Cash	2,000	
		Income		2,000
		Six months' interest on U. S. Treasury notes		
9	PFU	Cash	4,000	
		Unexpended balances		4,000
		Dividends on XYZ stock (Brown gift)		
10	AF	Income	2,500	
		Cash		2,500
10	AF	Cash	500	
		Due to endowment funds		500
10	AF	Principal	500	
		Income		500
		Since income was insufficient to provide for the payment to the donor, the deficiency is charged against principal		
10	EF	Due from annuity funds	500	
		Cash		500
11	EF	Cash	20,400	
		Merged investments		20,000
		Reserve for gains and losses on merged investments		400
12	SLF	Loans receivable	300	
		Cash		300
13	—	No entry		
14	CRF	Fund balance	200	
		Cash		200
15	AF	Cash	203,000	
		Investments		200,000
		Principal		3,000
15	AF	Due to endowment funds	500	
		Cash		500
15	EF	Cash	500	
		Due from annuity funds		500

Item	Fund			
15	AF	Principal	202,500	
		Cash		202,500
		Transfer of principal to plant funds. (*Note:* At the time notice of White's death was received, an entry could have been made transferring the principal balance in the form of investments.)		
15	PFU	Cash	202,500	
		Unexpended balances		202,500
16	SLF	Cash	750	
		Fund balance		750
		Six months' interest on Steam Power Co. bonds (Green fund)		
17	SLF	Cash	105	
		Loans receivable		100
		Fund balance		5
18	PFU	Unexpended balances	202,500	
		Cash		202,500
18	PFI	Buildings	250,000	
		Gifts invested in plant		202,500
		Mortgage payable		47,500

Auditing

November 4, 1954; 9 a.m. to 12:30 p.m.

Solution 1

a. The following documents should be on file with respect to each of the purchased notes:

(1) The original signed note of the mortgagor, with executed assignment thereof from the mortgagee to your client.

(2) Mortgage deed (or bond) running from the mortgagor to the original mortgagee, with executed assignment from the selling bank to your client.

(3) Certificate of title (and title insurance policy, if required).

(4) Fire insurance policy and such other insurance policies as it is customary for your client to require; for example, windstorm or tornado.

(5) Copies of any supplemental agreements between the mortgagor and original mortgagee, concerning such matters as the amounts of monthly payments on the notes and payments on account of taxes and insurance.

b. The audit of transactions would include the following:

(1) Preparation of or obtaining from the client a working-paper schedule of the notes, showing in columnar form the data necessary for the audit.

(2) Determination, from the seller of the mortgage note, of the amounts held in escrow at the close of the period under audit.

(3) Submission of letter of confirmation to the mortgagor, covering principal balance, interest condition and amounts held in escrow.

(4) Examination of the agreement for purchase of the notes, including a check on the authorization of the purchase and on the amount paid.

(5) Verification of accrued interest paid to the seller of the mortgage note.

(6) Comparison of recorded principal and interest collections on your client's records from date of acquisition of the note to the end of the year, with the schedule of agreed payments.

(7) Verification of income charges and credits relating to amortization of premium and discount on the purchased note.

(8) Tracing of some individual interest collections into the general ledger income account.

(9) Determination of proper recording in land records of the mortgage deed and assignment thereof.

(10) Determination that proper clauses are included in insurance policies, assuming that your client has first claim on proceeds of such policies.

(11) Determination that all taxes and liens on the mortgaged property have been paid.

Solution 2

a. This situation requires the auditor to follow two courses of investigation. These are (1) to determine that all charges applicable to the job have been properly recorded at the year end, and (2) to determine whether or not an inventory write-down is in order.

The audit procedures necessary to accomplish the foregoing are:

(1) To determine that all charges applicable to the job have been properly recorded. If direct charges to jobs are made for materials and parts the procedures would include:

  (a) Review the company's year-end cutoff methods.

  (b) Examine vouchers for the early part of the subsequent period for possible additional charges.

  (c) Examine vouchers for latter part of period under review for charges representing undelivered material or services.

  (d) Review the methods used in determining overhead rates and the manner in which jobs are charged for overhead to see that the job in question has been proportionately charged.

(2) To determine whether or not an inventory write-down is in order:

  (a) Inquire of the company's engineers the method or principles used in determining the percentage of completion. The percentage given may apply only to the labor factor, or it may apply to the total dollar value. If the percentage relates to dollar value, the material element should be scrutinized; since in many instances 100% of material costs are incurred at an early stage. Proper analysis of all elements should be made in the light of further information obtained concerning the percentage of completion.

  (b) Assuming that the percentage of completion relates to dollar value and that there are no other extenuating circumstances, it would appear that final cost will be about $55,000, which is in excess of contract price. Investigate the reasons for the excess costs. If specifications have been changed by the customer, it is possible that additional consideration will be obtained either as a result of the contract provisions or by negotiation. In any event, the possibility of obtaining an increase in price should be explored.

  (c) Revalue the job as indicated in part *b* to this answer.

  (d) It is possible that the contract may be a "loss-type" contract (i.e., entered into with full knowledge that a loss will be incurred but desirable because of its experimental nature). Losses so incurred are frequently considered as a form of experimental expense, and the contracts are entered into in the expectation of future business. When this is the case, the losses may be absorbed over the life of the contract. As applied to this contract, 55% of the losses indicated in part *b* of this answer should be recorded currently.

(e) If the loss is due to poor estimating or uncontrollable subsequent events (such as changes in labor rates), all other jobs, including those on which no work has begun, should be reviewed to determine possible existing loss situations.

b. If no price adjustment is possible and no worse experience is anticipated, the job should be valued at year-end at lower of cost or market as follows:

Selling price	$50,000
Costs to complete	(24,750)
	$25,250
Expenses (10% of sales)	(5,000)
Net realizable value (A)	$20,250*
Profit margin (5% of sales)	(2,500)
Net realizable value reduced by profit margin (B)	$17,750**

*Indicated loss of $10,000.
**Indicated loss of $12,500.

Either (A) or(B) may be used for an inventory value. The advance payment made by the customer is treated as a current liability. A third possibility would be to value the inventory at $19,125, which would charge only 45% of the normal profit to the current period. This might be justified on the theory that the following period should have a normal profit on the work done during that period. However, there is no obligation to write-down below $20,250.

Solution 3

a(1)
Item

1. Discussion of this matter probably has been going on for some time and the auditor could readily learn of it. Information of this sort undoubtedly would appear in the news. In any case the auditor should obtain from the appropriate officer of the company a statement that all liabilities have been recorded.
2. The auditor should have inquired closely into the status of income taxes for prior years and should have known of this possibility ahead of time.
3. The amount of liability for pending litigation cannot be determined; but an auditor could learn of an event of this nature from the press, or from a statement by company officials or company counsel, which statement he should obtain.
4. Information of this nature can be determined by reading the minutes.
5. If the amount of the transaction is not material it should be disregarded. A transaction of some magnitude would require protracted negotiations, and the auditor could learn of it through discussion with company officials or by reference to correspondence in the company files.

a(2)

Significant events which occur subsequent to the balance-sheet date and about which the auditor has knowledge before his report is completed may be of three types:

(a) Events which affect *directly* the financial statements of the period under review. Such an event as the settlement of a contested liability or the determination of its amount usually provides a more accurate basis for statement of that liability than was available at balance-sheet date. Items 1 and 2 in this question are examples of this first type of event which requires recognition in the statements or in footnotes to them.

(b) Events of an accounting nature which, although not affecting the financial statements of the prior period directly, may have, if disclosed, such effects on the reader's interpretation of those statements or of future prospects as to make disclosure advisable. Items 3, 4 and 5 in this question are examples of this type of event, as are mergers or acquisitions, serious damage from casualties, and sale of a large bond issue with restrictive covenants.

(c) Events of a "non-accounting" nature, such as strikes, product changes, union contracts other than those with retroactive clauses, and war. Events of this third type usually do not require recognition in the financial statements or attached notes. Indeed, their effects on future operations and financial condition may be so conjectural and so subject to different interpretations that the auditor usually should not give recognition to such strictly "non-accounting" events.

Generally, the auditor should give recognition to material events of the first two types when such disclosure *should* cause the reader of the financial statements to place upon the client's financial position and future prospects an interpretation different from that likely without knowledge of such events.

Specifically, the items in this question should receive the following recognitions:

Item

1. A liability should be set up on the balance sheet for the amount applicable to the period under review.
2. Any information which the auditor obtains concerning possible material income tax claims for open years should be disclosed in a footnote. If the company agrees to a part of the assessment, that part should be shown as a liability.
3. The existence and nature of the litigation should be disclosed by a footnote or, by the management, in the president's letter.
4. Such a declaration usually is disclosed in a footnote.
5. If this sale materially affects the *future operations* of the company, it should be disclosed in a footnote.

b. The auditor must observe generally accepted auditing standards in order to merit confidence in his opinion. These have been stated by the AIA's Committee on Auditing Procedure as follows (AIA, Generally Accepted Auditing Standards, 1954, pp. 12-13):

"Group I: Personal or general standards—governing both field work and the reporting thereon—reflecting the standards which require that the 'generally recognized normal auditing procedures' be applied with *'professional competence by properly trained persons.'*

"Group II: Standards for—

(a) The conduct of the field work, and

(b) the reporting thereon,

reflecting those *'auditing standards* (which) *may be regarded as the underlying principles of auditing which control the nature and extent of the evidence to be obtained by means of auditing procedures.'* "

Solution 4

a. Cut-off is a term applied in the determination of completed transactions. In a restricted sense it refers to the particular one out of a series of transactions which is the dividing point between items included and items excluded. It has particular significance in audits for two reasons. First, there is the danger that only one portion of a transaction may be recorded at the end of a period, with a resulting misstatement of income in the current and in the following period. This might happen, for instance, where a sale is recorded but cost of sales is not charged until later. Its second importance is because of the possibility of both elements being recorded in the wrong period, resulting in misstatement of income and/or of financial position.

b. The point at which a sale is effective for accounting purposes is determined, in most instances, by the delivery of the goods or services. At such point it is in order to record the sale as such and to include the amount as "Accounts receivable." Delivery receipts of the last few days of the period should be inspected to determine that the shipments corresponded with the entries to Sales and Accounts receivable.

Similar measures should be taken to determine that the purchases and inventories include all receipts of merchandise and services in the appropriate accounting period and that the corresponding credit is recorded in the Accounts payable accounts. Reference to receiving slips is necessary to ascertain that care has been taken to have correct accounting for all receipts and that the transactions of the subsequent period have been excluded.

The matter of consignment sales and also of commitments may also be covered, in part, through this procedure; but it does not cover the verification of goods in transit.

Solution 5

In addition to discussions concerning the clerical procedures mentioned, the following are some of the items you would include in your discussion with the client:

a. The exact date and time at which the inventory will take place.
b. The arrangement of the stock so as to facilitate the count. Provision should be made to assure its proper identification and description either by tagging or some other method.
c. The method to be used in segregating obsolete or damaged items of inventory.
d. Procedures to be followed by the client in counting and recording the stock, including the organization of the inventory teams.
e. Procedures to be followed where differences arise between the original count and that of the auditor's representative.
f. Procedures to be followed in gathering the tags or inventory sheets and in maintaining control thereof.
g. Methods to be used to assure proper cut-off of purchases and sales.
h. Procedures to be followed with respect to goods out on consignment, if any, and goods held on consignment.

Solution 6

Determine by observation and inquiry what kind of inventory and cost records the client maintains, how often physical inventories are taken and how often audits have been made by independent certified public accountants.

If an audit had been made the previous year by a firm in which you have confidence and the auditors had followed the normal auditing procedures of observation of physical inventories, after discussion with the firm making the previous audit, procedures could be limited to a general review of the final inventory sheets for the opening inventory. This review would consist primarily of a general overall comparison of the inventories of the two periods broken down by appropriate classifications as to quantities, valuation, and basis of pricing, and overall tests of the reasonableness of the inventory.

If, for any reason, reliance can not be placed on a previous year's audit, additional steps are necessary. Tests of the underlying records supporting the amount stated for inventories at the close of the preceding year would be made. Inquiries would be made of officers and employees having responsibility for the physical inventory-taking to determine the methods and procedures employed, and whether the procedures were the same as those employed with respect to the closing inventory. Inventory instructions would be reviewed and test checks made of the original worksheets and assembly sheets to the final inventory sheets.

In a situation of this kind, overall tests are important. These would include comparing the various components in the inventories for a few prior years to study the pattern in relation to sales, costs, gross profit and turnover. Computation and comparison of turnover and gross profit percentages for several years would be helpful indications of the credibility of the inventory at the first of the year.

Solution 7

As part of the audit program for the interim audit work, a review probably has been made of the system of internal control. Such review would include following through certain selected transactions (such as purchases, sales, and cash receipts and payments) from the original source to their final disposition; noting proper approvals, authorizations and so forth.

Based upon the results of that review, greater stress might be placed upon one portion of the audit program than upon another. However, in general, the following steps would appear to be desirable for the items noted:

ADVERTISING

Vouch two months' advertising bills to the actual advertisements placed, noting that the newspaper or magazine spaces paid for were actually used and checking the amount of agency commission for the total advertising expenditure.

Scan the charges to the advertising account for the balance of the year to see that they are essentially in the same manner and amount as those of the two months audited in detail. Investigate any unusual items. Check expenditures against the advertising budget.

Review the advertising expense for the last month of the fiscal year to determine that all expenditures are applicable to the year.

RENT

Inspect the lease, making excerpts of important features for the workpapers. Watch for clauses which may indicate additional rent such as under a percentage lease or increases governed by the passage of time. Also notice any obligations on the part of the tenant for maintenance, restoration or similar duties.

Check the total rent for the year to the lease terms.

Vouch two months' rent to see that the check is drawn to the proper payee.

SALESMEN'S COMMISSIONS

Inquire whether there are any written contracts with salesmen. If there are, obtain excerpts from them. If there are no contracts, obtain a schedule from an authorized top executive of the client indicating the approved rates of commission and general terms of employment of each salesman.

Compare sales by salesmen for the two months audited in detail with the commissions paid. Calculate the correctness of the amounts.

Review breakdown of actual sales by salesmen and scan the correctness of the commission paid each salesman for the year.

Scan carefully payments to salesmen during the last month of the year under review, as well as the month following, in order to ascertain that proper accrual is made at the balance-sheet date for any unpaid commissions.

INSURANCE

Obtain a schedule of the insurance policies in force, either from the bookkeeping department or the insurance broker.

Inspect the insurance policies. Check them to the schedule noting the amount and type of coverage, the total premium, the period of coverage and the unexpired premium.

Confirm with the insurance broker whether any binders have been placed for additional coverage which may be accruable at the balance-sheet date.

Compare the total fire insurance coverage with the book and present value of the assets involved.

If there is any lack of coverage, either as to type or amount, notify the client in writing.

Note that charges to the insurance expense account relate to specific policies.

Inquire as to the possibility of any additional assessments or payments due under such policies as reporting policies or mutual insurance policies.

See that proper accrual is made, and review the applicable rates in relation to compensation insurance.

Tie in expense with the write-off of prepaid and check expense distribution to appropriate accounts.

Solution 8

a. To reconcile all bank activity with the books for the period before and after the year-end while avoiding as many detailed comparisons as possible dictates the use of a reconciliation which ties through all transactions.

ABC CORPORATION

Reconciliations of Bank Balances and Bank Activity with Books

December 1, 1953 to January 12, 1954

	Balance	*Month of December*		*Balance*	*January 1-12*		*Balance*
	12/1/53	*Receipts*	*Disbursements*	*12/31/53*	*Receipts*	*Disbursements*	*1/12/54*
Amounts per bank statements	$27,324.08[4]	$86,324.00	$93,264.19	$20,383.89[4]	$24,372.10	$15,241.15[2]	$29,514.84[4]
Outstanding checks:							
Beginning of period	(7,324.13)		(7,324.13)			(8,231.12)[3]	
End of period			8,231.12	(8,231.12)[1]		3,172.50	(3,172.50)[5]
Deposits in transit:							
Beginning of period	2,200.00	(2,200.00)			(3,750.00)		
End of period		3,750.00		3,750.00[1]	1,625.00		1,625.00[5]
Adjustments:							
Bank charges	11.50		{(13.25) 11.50	13.25		13.25	
Bank error (check #28890 cleared at $122.48 instead of $22.48)			(100.00)	100.00	(100.00)		
Note collected on 11/28/53, recorded 12/10/54	(1,000.00)	1,000.00					
Collection fee on above entered as disbursement	3.50		3.50				
Returned checks:							
A. Black (returned 12/16; redeposited 12/8; not recorded at all)		(327.50)	(327.50)				
C. Denny (returned 12/27; recorded in red in cash receipts book 1/3)			(673.84)	673.84	(673.84)		
Payroll checks (for vacation):							
Drawn on Jan. 3, cleared Jan. 8, not recorded as disbursement until regular payroll Jan. 15						(215.75)[7]	215.75
Amounts per books	$21,214.95[6]	$88,546.50[6]	$93,071.59[6]	$16,689.86[6]	$21,473.26[6]	$ 9,980.03[6]	$28,183.09[6]

c. AJE#1—Bank charges for December	$ (13.25)
#2—Returned check—C. Denny	(673.84)
Adjusted balance 12/31/53	$16,002.77

b. Since this reconciliation ties up deposits and checks from November 30 through January 12, any possibility that "kiting" took place could be determined by the following steps (see keyed items in reconciliation):

(1) Check the deposits in transit on December 31 into the bank in January to determine that they were received promptly and that they did not contain any bank transfer checks not recorded as outstanding.

(2) Determine that none of the checks paid in the early part of January represented transfers which were in December deposits, except to the extent that they were included in December 31 outstanding checks.

(3) Inspect the checks outstanding on December 31 that were returned in January to determine that they were properly identified as to payee.

A number of additional procedures would be appropriate as to the audit of cash in banks, although not necessary to detect "kiting." Included would be the following:

(4) Check to confirmations received

(5) Trace to bank statement of January 31, 1954

(6) Compare with cash book and/or general ledger

(7) Trace to payroll record

(8) Inspect checks for indorsements, cancellations and so forth

Commercial Law

November 5, 1954; 9 a.m. to 12:30 p.m.

Solution 1

a. 1. A condition precedent refers to those facts or events which must exist or occur before a duty of immediate performance of a promise arises. (*Restatement, Contracts,* Sec. 250(a) (1932); 3 Corbin, *Contracts,* Sec. 628 (1950); 3 Williston, *Contracts,* Sec. 666A (Rev. ed., Williston and Thompson, 1936).)

2. A condition subsequent refers to those facts or events the existence or occurrence of which divests the duty of immediate performance of a contract after it has once accrued. Such conditions are rare, but do exist. For example, where goods are sold with a right to return, a duty of immediate performance to pay the price arises when the goods are sold (unless a period of credit was agreed upon), but this duty, though violated by failure to pay at once, may be divested by the return of the goods. (3 Williston, *Contracts,* Sec. 667.)

3. Concurrent conditions are mutual conditions precedent. A concurrent condition is a condition precedent which exists only when parties to a contract are bound to render performances at the same time; and the fact constituting the condition is, alternatively, either (a) performance by one party before performance by the other, or (b) an offer, accompanied with manifested present ability to make it good, to perform if the other simultaneously performs. In effect concurrent condition is an elliptical expression for a condition precedent where performances are due at the same time. If either performance is actually rendered before or when it is due, this will be not only a performance of a duty but of a condition on which the duty of the other party depends. The condition may also be performed, however, by making such an offer as is stated in (b), and this constitutes the special feature of concurrent conditions. (3 Williston, *Contracts,* Sec. 666A; *Restatement, Contracts,* Sec. 251. and comment a.)

b. Yes. As a general rule the courts will not inquire into the adequacy of consideration. (*Restatement, Contracts,* Sec. 81; 1 Corbin, *Contracts,* Sec. 127; 1 Williston, *Contracts,* Sec. 115; 12 Am. Jur., *Contracts,* Secs. 72, 122 (1938).)

An exception to the general rule arises when the consideration is a transfer of money or fungible goods for a promise to transfer at the same time and place a larger amount of money or goods of the same kind and quality. (*Restatement, Contracts,* Sec. 76(c); 1 Corbin, *Contracts,* Sec. 129; 1 Williston, *Contracts,* Sec. 115; 12 Am. Jur., *Contracts,* Sec. 123.)

Even where the consideration is not of the same nature as the thing promised, if it is inadequate to an extreme degree there is a tendency on the part of some courts to refuse to apply the rule on the ground that there had been no bargain in fact and that the stated consideration was a mere pretense. However, this tendency has not been carried very far. (1 Corbin, *Contracts,* Sec. 127; 1 Williston, *Contracts,* Sec. 115.)

Gross inadequacy of consideration may be important, in connection with other relevant factors, as evidence of fraud, misrepresentation, undue influence or duress (*Restatement, Contracts,* Sec. 497, comment b; 1 Corbin, *Contracts,* Secs. 127, 128; 1 Williston, *Contracts,* Sec. 115), proof of which frees the promisor from his obligation. (*Restatement, Contracts,* Secs. 475-76, 494-95, 497; 12 Am. Jur., *Contracts,* Secs. 145-48.)

There may be situations where, though the promisee is entitled to a judgment for damages, his consideration is sufficiently inadequate to deprive him of the remedy of specific performance. (*Restatement, Contracts,* Sec. 367(a) and Comments a and b.)

c. No. It is well settled that a gratuitous assignment is effective as against the obligor. (*Restatement, Contracts,* Sec. 150(2); 4 Corbin, *Contracts,* Sec. 909; 2 Williston, *Contracts,* Sec. 438A..)

d. A unilateral contract is one in which no promisor receives a promise as consideration for his promise. A bilateral contract is one in which there are mutual promises between two parties to the contract, each party being both a promisor and a promisee. (*Restatement, Contracts,* Sec. 12; 1 Corbin, *Contracts,* Sec. 21; 1 Williston, *Contracts,* Sec. 13.)

Solution 2

a. The chattel mortgage and the conditional sale accomplish the same result but operate on different theories. Where the seller of chattels takes back a chattel mortgage upon the goods, he passes title to the buyer and then takes back the title as security or takes a lien on the goods, dependent on whether the lien or conveyance theory of chattel mortgages is in force in the particular jurisdiction. Under a conditional sale, title never passes from the seller until payment, but is held back as security to compel payment or the performance of some other act. In both cases the seller gets rights in the goods sold as security, but the steps by which the result is reached are theoretically different. (Bogert, *Commentaries on Conditional Sales,* Sec. 10 (*Uniform Laws Ann.* 2 A, 1924), including 1954 Cum. Supp.)

b. Yes. According to the weight of authority, where the payment of so-called rent agreed upon is approximately equal to the price of the leased goods, the transaction contemplates the ultimate ownership of the property by the so-called lessee (not its return to the lessor), and the transaction is regarded as a conditional sale. The so-called rent is regarded as payment of the price in installments.

The required payment of an additional sum before exercise of the option to become owner of the leased goods does not affect the nature of the transaction where, as in the instant case, the additional payment is relatively small. (Bogert, *Commentaries on Conditional Sales,* Sec. 13 (*Uniform Laws Ann.* 2 A, 1924), including 1954 Cum. Supp.; 2 Williston, *Sales,* Sec. 336 (rev. ed., 1948), including 1954 Cum. Supp.)

This rule was codified by Sec. 1 of the Uniform Conditional Sales Act, which has been adopted in approximately one-fourth of the states, including the important commercial states of New York and Pennsylvania. The Act defines "conditional sale" as "any contract for the bailment or leasing of goods by which the bailee or lessee contracts to pay as compensation a sum substantially equivalent to the value of the goods, and by which it is agreed that the bailee or lessee is bound to become, or has the option of becoming the owner of such goods upon full compliance with the terms of the contract."

Solution 3

a. Sloan may not recover. A promise not to prosecute for the commission of a crime is illegal and is not a valid consideration. The defense of want of a valid consideration was available to the maker of the note as between the maker and its payee. It was also available to the maker as against Sloan, who purchased the note after maturity for value, unless there was an intervening holder in due course whose acquisition of the note cut off such defense. Sloan was not a holder in due course as he purchased after maturity. Although not stated in the question, the answer assumes that there was no intervening holder in due course. (6 Corbin, *Contracts,* Sec. 1421 (1950); Uniform Negotiable Instruments Law, Secs. 28, 52(2), 57 and 58.)

b. Drew can recover $800. Drew was a holder in due course of the check because when it was acquired by him it was complete and regular upon its face, he acquired it in good faith, for value, with no notice of any infirmity or defect in title and before it was overdue. As such holder in due course he was entitled to enforce it for the full amount of $800. In the hands of such a party the check could be enforced as if it had been filled-in strictly in accordance with the authority given. (Uniform Negotiable Instruments Law, Secs. 52 and 14.)

Solution 4

a. Among the major duties and obligations of an agent to his principal are the following: (1) to act with the standard care and skill which is standard in the locality for the kind of work which he is employed to perform; (2) to refrain from acting with such impropriety as to bring disrepute upon the principal or the business in which the principal is engaged; (3) to use reasonable efforts to give his principal relevant information; (4) to keep and render to his principal an account of money received or paid out on behalf of the principal; (5) to refrain from exceeding his authority; (6) to obey all reasonable directions of his principal in regard to the manner of performing the service he has contracted to perform; (7) to be loyal to his principal; (8) to account to his principal for profits arising out of his employment; (9) to refrain from acting as a party adverse to his principal without his principal's consent; (10) to refrain from competing with his principal concerning the subject matter of the agency; (11) to refrain from using or communicating information confidentially given by his principal in competition with or to the injury of his principal. (*Restatement, Agency,* Secs. 379-398.)

b. A principal is undisclosed when the other party has no notice that the agent is acting for a principal. However, if the other party has notice that the agent is or may be acting for a principal but has no notice of the principal's identity, the principal for whom the agent is acting is considered to be partially disclosed. (*Restatement, Agency,* Sec. 4.)

c. The doctrine of imposing liability on a principal for acts of the agent committed within the general scope of the agent's employment does not generally apply with respect to criminal responsibility. Normally the principal is not responsible for crimes committed by the agent unless the principal in some way participates in, countenances or approves of what the agent does. However, there are instances in which vicarious criminal responsibility is imposed on the principal for acts of the agent. For example, under pure food laws and intoxicating liquor laws the principal may be held criminally responsible for acts of his agent without any fault on the part of the principal. (2 Am. Jur., *Agency,* Sec. 383 (1936).)

d. An "agency coupled with an interest" exists when the agent has an interest or estate in the subject matter of the agency, independent of the power conferred upon the agent. Thus, if the agent's interest is merely his right to receive, by way of compensation or commission, a certain amount from, or percentage of, the proceeds of a sale effected by him, no agency coupled with an interest exists. On the other hand, a factor who makes advances against merchandise which is in his hands for sale has an agency coupled with an interest, his claim against the merchandise for the advances made being the interest he has in the subject matter of the agency. An "agency coupled with an interest" vests irrevocable authority in the agent and the phrase is often used synonymously with "irrevocable agency." (2 Am. Jur., *Agency,* Secs. 78, 84 and 77; Conyngton and Bergh, *Business Law,* p. 211 (4th ed., 1949); Ferson, *Principles of Agency,* Secs. 201, et seq. (1954).)

e. If the principal and agent have entered into a valid contract to the effect that the agency can not be revoked the principal nevertheless continues to have the power to revoke the agency, but if he does revoke he must respond in damages for breach of his contract not to revoke. However, when the agency is one coupled with an interest the principal not only has no right to revoke but also has no power to revoke. (*Restatement, Agency,* Sec. 139; Ferson, *Principles of Agency,* Sec. 204; C.J.S., *Agency,* Secs. 73, 74 and 75 (1936).)

Solution 5

a. No. A contractual duty or a duty to make compensation is discharged where performance is subsequently prevented by a valid municipal regulation. (*Restatement, Contracts,* Sec. 458(a) and Comments a and c; 6 Corbin, *Contracts,* Sec. 1343; 6 Williston, *Contracts,* Sec. 1938.)

b. Yes. The action of Apex Corporation in advising Graham that it would not make delivery constituted an anticipatory breach of the contract entitling Graham to bring suit immediately. The action of Graham in bringing the suit prevented Apex Corporation from withdrawing its statement that it would not make delivery, had it wished to withdraw such statement. (*Restatement, Contracts,* Secs. 318, 319.)

Solution 6

a. No. Section 64a (2) of the National Bankruptcy Act, in extending priority to claims for wages, limits such priority to wages not exceeding $600 in amount which were due and earned within three months of the commencement of the bankruptcy proceeding and which were earned by workmen, servants, clerks or traveling or city salesmen. Here Reilly was not a workman, servant, clerk, traveling or city salesman and consequently would be entitled to no priority. (*Blessing* v. *Blanchard,* 223 Fed. 35 (9th Cir. 1915); *In re Bonk,* 270 Fed. 657 (E.D. Mich. 1920); *In re Greenberger,* 203 Fed. 583 (N. D. N. Y. 1913); 3 Collier, *Bankruptcy,* 14th ed., para. 64.204.)

b. No. Under Sec. 127 of the Bankruptcy Act (11 U.S.C., Sec. 527 (1952)), a petition for corporate reorganization may be filed before or after the adjudication of bankruptcy.

c. The statements which a petition for corporate reorganization under the Bankruptcy Act must set forth are concerned with the following subjects: (1) The fact that the corporation is insolvent or unable to pay its debts as they mature; (2) the applicable jurisdictional facts required under Chapter X of the Act; (3) the nature of the business of the corporation; (4) the assets, liabilities, capital stock and financial condition of the corporation; (5) the nature of all pending proceedings affecting the property of the corporation known to the petitioner or petitioners and the courts in which they are pending; (6) the status of any plan of reorganization, readjustment or liquidation affecting the property of the corporation, pending either in connection with or without any judicial proceeding; (7) the specific facts showing the need for relief, and why adequate relief cannot be obtained under Chapter XI (on Arrangements); and (8) the desire of the petitioner or petitioners that a plan be effected. It has been suggested that as under Sec. 126 of the Act, 11 U.S.C., Sec. 526 (1952), a petition may be filed only if there is no other petition for reorganization by or against the debtor pending, it may be necessary to allege that there is no such petition pending. (Sec. 130 of the Bankruptcy Act, 11 U.S.C., Sec. 530 (1952); 6 Collier, *Bankruptcy,* para. 4.04.)

d. The court must be satisfied:

1. (a) That the arrangement has been accepted in writing by all creditors affected thereby at the prescribed creditors' meeting, whether or not their claims have been proved; or

   (b) that the arrangement has been accepted in writing by a majority, in number and amount, of all creditors (or, if the creditors are divided into classes, by a majority, in number and amount, of creditors of each class) affected by the arrangement, whose claims have been proved and allowed before the conclusion of the prescribed creditors' meeting.
2. That the debtor has made the required deposit of any necessary funds.
3. That the arrangement is for the best interests of the creditors.
4. That the arrangement is fair, equitable and feasible.

5. That the debtor has not been guilty of any of the acts or failed to perform any of the duties which would be a bar to the discharge of a bankrupt.
6. That the proposal and its acceptance are in good faith and have not been made or procured by any means, promises or acts forbidden by the Act. (Secs. 361, 362 and 366 of the Bankruptcy Act, 11 U.S.C., Secs. 761, 762, 766; 8 Collier, *Bankruptcy,* para. 9.01.)

Solution 7

a. 1. Valid. The pressure must be wrongful for it to constitute duress and not all pressure is wrongful. Thus it is not duress for a creditor to threaten to take the means provided by law for the enforcement of claims, whether or not he may actually recover, so long as the threat is made in good faith, *i.e.,* in the honest belief that a possible cause of action exists. (*Restatement, Contracts,* Sec. 493 (b); 5 Williston, *Contracts,* Sec. 1606.)

2. Probably voidable. Although there is a substantial body of authority to the effect that a threat of imprisonment or prosecution does not constitute duress when the accused is guilty, another line of authorities, generally regarded to be supported by the better reasoning, holds that although the party to the contract is actually guilty, if the threat is of sufficient compelling force to render the acts done under its influence coerced, the agreement is voidable. (*Restatement, Contracts,* Secs. 492(b), 493(b) and 493, Comments c and d; 5 Williston, *Contracts,* Secs. 1603, 1612 and 1616; 17 Am. Jur., *Duress and Undue Influence,* Sec. 13 (1948).)

3. Probably voidable. Although the early common law did not regard as duress the mental pressure exerted by threats to injure a person other than the one whose action was coerced, an exception was made where duress was exercised against the husband or wife or child of the person whose action was coerced, and this exception has been extended to include all near relatives. This exception has been applied in many instances of threats of wrongful imprisonment or prosecution of a husband or wife of the party with whom the contract was made (5) Williston, *Contracts,* Sec. 1621; *Restatement, Contracts,* Sec. 493(c)), and the probability is that it would also be applied in instances of other wrongful threats to injure the spouse of the party with whom the contract is made, including a threat to publish defamatory matter concerning such spouse.

b. Yes. If either the formation or performance of a bargain is prohibited by statute the bargain is considered illegal. (*Restatement, Contracts,* Sec. 580; 7 Fletcher, *Cyc. Corps.,* Sec. 3595 (rev. ed., Jones, 1931); 6 Williston, *Contracts,* Secs. 1763, 1771.) The effect of the illegality generally is for the courts to deny relief to either party and leave them where they stand. (*Restatement, Contracts* Sec. 598 and Comment a, Sec. 580; 6 Williston, *Contracts,* Sec. 1762.)

Solution 8

a. No. Indication of acceptance is not required for Jones to acquire title. When goods are delivered to the buyer on approval and the buyer does not signify his approval or acceptance but retains the goods without giving notice of rejection and no time has been fixed for the return of the goods, title passes to the buyer on the expiration of a reasonable time. What is a reasonable time is a question of fact. (Uniform Sales Act, Sec. 19, Rule 3(2)(b).)

b. Probably no. In answering the question it has been assumed that if there were in fact a contract to the effect that all disputes regarding the sale were to be settled by arbitration the dispute arises in a jurisdiction in which a contract to arbitrate is enforceable but under the law of such jurisdiction such a contract must be in writing in order to be enforceable. In many jurisdictions a contract to arbitrate is not enforceable. Also in some jurisdictions in which such a contract is enforceable it is only enforceable if it is in writing.

If the invoice be regarded as a contract containing all the terms (including the agreement to arbitrate), its physical acceptance without signing it would result in a contract (including the agreement to arbitrate). However, such a contract would not be enforceable because it would not be in writing. On the other hand, if the invoice be regarded as merely an offer to enter into an agreement to arbitrate, silence in the face of the offer probably would not be considered as an acceptance of the offer.

Whether there was in fact a contract to arbitrate might well be a question for a jury to decide as a matter of fact.

In a case almost identical to the instant case, the New York Court of Appeals decided that there was no contract to arbitrate within the meaning of the New York statute providing that a contract to arbitrate a controversy thereafter arising between the parties must be in writing. (*Tanenbaum Textile Co., Inc.* v. *Schlanger*, 287 N. Y. 400, 40 N.E.2d 225 (1942); see also *Restatement, Contracts,* Secs. 70, 72.)

Solution 9

a. A board of directors of a corporation is the group responsible for matters of management of the corporation in connection with its regular and ordinary business affairs. It elects the corporate officers, determines their compensation and the compensation of employees, determines policies as to pricing, labor relations, expansion and new products, determines the time and amounts of dividends to be paid to stockholders, and has general supervision over the welfare and operation of the business of the corporation. The power of the board is, of course, subject to any restrictions which may be imposed by state constitution, statute, charter or by-laws. (Ballantine, *Corporations,* Sec. 42 (rev. ed., 1946); 2 Fletcher, *Cyc. Corps.,* Sec. 505 (rev. ed., Wolf, 1954.)

b. A voting trust agreement is a method of consolidating voting strength, normally for the purpose of insuring continuity of policy and management. Shareholders becoming parties to a voting trust agreement normally transfer their shares to a voting trustee, who thus becomes the registered owner of the shares on the corporate books and entitled to vote the shares. In exchange for the shares, the trustee issues voting trust certificates to the depositing shareholders representing an equitable interest in the shares transferred to him and in any shares subsequently allotted as stock dividends and entitling the depositing shareholders to ratable distributions of cash dividends paid by the corporation to the trustee. Unlike the proxy holder, who votes under an agency from the legal owner of the shares, an agency which is revocable unless coupled with an interest, the voting trustee votes as legal owner of the shares. (Stevens, *Corporations,* Sec. 121, p. 546 (2d ed., 1949).)

c. Minority stockholders may restrain or set aside: (1) Action or threatened action of the board of directors which is beyond the authority of the board or beyond the authority of the corporation under its charter; (2) fraudulent transactions threatened or completed by the directors which will result in serious injury to the corporation or to the interests of other shareholders; (3) action by the board for their own interest in a manner destructive of the corporation itself or the rights of the other shareholders; (4) an oppressive and illegal course of action by the majority of the shareholders in the name of the corporation. (10 Fletcher, *Cyc. Corps.,* Sec. 4860, pp. 282-285.)

d. As a general rule a shareholder is considered to have no direct individual right of action for corporate wrongs which impair the value of his investment. Injuries to the corporation, as by negligence, mismanagement or fraud of its directors, are normally dealt with as wrongs to the corporation, to be redressed in a suit by or on behalf of the corporation. Such an action is brought by the shareholder as a derivative action for the benefit of the corporation. However, before bringing such a derivative suit the shareholder must show that he has exhausted all means to obtain redress or satisfactory action within the corporation.

In some cases, however, although there may be a corporate injury, an individual right of action may also arise and the shareholder may sue and recover directly and individually for the loss inflicted upon him. In such a case, of course, he need not establish that he has exhausted all means to obtain redress within the corporation. An illustration of such a suit is one in which an injunction is sought against a threatened illegal or ultra vires transaction on the part of the corporation and its officials and the only relief is preventive. In such a case there is no practical need of imposing the restrictions of a representative suit upon the objecting shareholder as there will be no recovery of corporate assets for the benefit of an individual plaintiff. (Ballantine, *Corporations,* Secs. 143, 146; 10 Fletcher, *Cyc. Corps.,* Sec. 4860; Stevens, *Corporations,* Sec. 169.)

Solution 10

a. The Fair Labor Standards Act covers all employees engaged in commerce or in the production of goods for commerce (Sec. 6(a), 29 U.S.C., Sec. 206(a) (1952)), with certain exemptions (Secs. 3 (d) and 13, as amended, 29 U.S.C., Secs. 203(d), 213). "Commerce" is defined in Sec. 3(b) of the Act, as amended, as "trade, commerce, transportation, transmission or communication among the several States or between any state and place outside thereof." (29 U.S.C., Sec. 203(b).) Sec. 3(j), as amended, provides that "an employee shall be deemed to have been engaged in the production of goods if such employee was employed in producing, manufacturing, mining, handling, transporting, or in any other manner working on such goods, or in any closely related process or occupation directly essential to the production thereof." (29 U.S.C., Sec. 203(j).)

The principal exemptions are employees of federal, state and local governments, those employed in a bona fide executive, administrative, professional or local retail capacity or in the capacity of outside salesmen, seamen and agricultural employees. (Handler and Hayes, *Cases and Materials on Labor Law,* 561 (2d ed., 1953).)

b. 75 cents an hour. (Sec. 6(a)(1), as amended, 29 U.S.C., Sec. 206(a)(1).)

c. 40 hours a week. (Sec. 7(a), as amended, 29 U.S.C., Sec. 207(a).)

d. At a rate not less than one and one-half times the regular rate at which he is employed. (Sec. 7(a), as amended, 29 U.S.C., Sec. 207(a).)

Solution 11

a. No. The question inquires whether "Blanchard's refusal to testify would be upheld." The privilege, if it exists, would be a privilege of Blanchard, the client, and apparently the question means that the client, Blanchard, refused to permit the certified public accountant to testify and attempted to invoke the privilege. Although a privilege was recognized at common law to protect the confidential relationship between attorney and client, no such privilege was recognized with respect to accountant and client. (8 Wigmore, *Evidence,* Sec. 2286.)

b. Generally speaking, some of the statutes which provide that communications between client and accountant are confidential and privileged and not to be divulged make no restriction as to the type of legal proceedings in which the privilege applies, whereas others provide specifically that the privilege does not apply in situations involving criminal or bankruptcy laws. (Levy, "Legal Responsibility and Civil Liability," p. 53, c. 6, 1 *CPA Handbook* (Kane ed., 1952).)

c. Generally such statutes contain a specific provision that permission of the client relieves the accountant of his obligation under the statute not to testify. Some of the statutes require such permission to be in writing. It should be noted that there are in all probability other instances in which the accountant becomes relieved of his obligation under the statute even though there is no specific provision in the statute covering the case. For example, if the client should sue the accountant in a matter involving the facts as to which the privilege is claimed, the client doubtless would be treated as having waived the privilege by bringing the suit, thus freeing the accountant of his obligation not to testify. Also if a third party should sue the accountant on the basis of a statement made in the accountant's report published by the client, the action of the client in publishing the report would doubtless be considered as amounting to a waiver of the privilege on the part of the client permitting the accountant to testify. (Levy, *supra,* at pp. 53, 56.)

Solution 12

The answers to Question 12 given below are based on the Uniform Partnership Act and the Uniform Limited Partnership Act to the extent that they contain provisions bearing on the question. These acts have been adopted in over 30 states. As to questions with respect to which the Acts are silent, the answers are based on what is considered to be the generally prevailing view.

Item	*Answer*	*Source of Answer*
1.	False	Sec. 7(4)(b) of the Uniform Partnership Act.
2.	False	Secs. 2, 6(1) of Uniform Partnership Act.
3.	False	Sec. 8(3) of Uniform Partnership Act.
4.	True	Sec. 25(2)(e) of Uniform Partnership Act.
5.	True	Sec. 26 of Uniform Partnership Act.
6.	True	Sec. 23(2) of Uniform Partnership Act.
7.	True	Sec. 4(3) of Uniform Partnership Act.
8.	False	Crane, *Partnership,* Sec. 26 (1952); 40 Am. Jur., *Partnership,* Sec. 504 (1942).
9.	True	Crane, *Partnership,* Sec. 22; 40 Am. Jur., *Partnership,* Sec. 10.
10.	False	Sec. 1 of Uniform Limited Partnership Act.

Theory of Accounts

November 5, 1954; 1:30 to 5 p.m.

Solution 1

1. A
2. A.
3. B.
4. A.
5. B.
6. B and E (or E).
   Under the *construction-period theory*—which although not mandatory, apparently is intended to be followed by this client—all costs relating to the construction and incurred during such period may be capitalized. Therefore, that portion of the bond discount and issue costs which by a process of amortization are allocable to the construction period may be charged to *Buildings,* with the remainder deferred in a *Bond discount and expense* account. In any case, *total* discount and issue costs may not be capitalized in the *Buildings* account.
7. B. (Or D, if answer to item 6 is "E" with statement that *construction-period theory* is not to be followed.)
8. E. The client's procedure and aim would be appropriate in accumulating data for a management decision such as whether to use company funds or to borrow. However, it is not an acceptable procedure for financial reporting. No interest cost has been incurred and the interest "saved" cannot be viewed as a revenue. The client's entry for this item should be reversed.
9. B and D.
10. B.
11. A.
12. B.
13. B.
14. B.
15. B.
16. A and B.
17. B.
18. A.
19. A or E. There are advantages in segregating this item in a *Land improvement* account, permitting its write-off where the life is short or where the improvement may not be replaced.
20. B.
21. B.
22. B and D.

23. B.
24. E. Transfer to *Machinery and equipment* account. Costs of installation are proper charges to the asset account to which they relate.
25. E. Reverse the client's entry. Although the formula used by the client is sound in general as a means of estimating the "saving" (net profit) achieved by self-construction, this "saving" cannot properly be reflected in financial reporting. There has been no realization of revenue.

Solution 2

While there may be some criticism of the form of the statement since it is relatively uncommon, no adverse criticism is warranted on that point. The valid points of adverse criticism are:

a. No date is given for the statement.
b. The basis on which the inventory is stated is not given.
c. Unamortized bond discount should not be classed with prepaid expenses if the current-asset treatment of prepaid expenses is to be followed.
d. The basis on which property, plant and equipment is stated is not given.
e. Buildings and equipment probably should be listed separately.
f. The amount of accumulated depreciation should be stated.
g. Additional information should be given on the common stock:
   (1) The number of shares authorized, issued, and outstanding.
   (2) Whether the stock is no-par or par value stock, and if the latter, the amount of par value per share should be given.
h. It may be desirable to indicate which assets are pledged for the mortgage bonds.

Solution 3

a. On a consolidated balance sheet the purchase of this equipment should not affect the asset valuation since there is no evidence that the value of the equipment has increased. The necessary elimination entry is:

Equipment	$15,000	
Retained earnings	2,000	
Accumulated depreciation		17,000

The depreciation which will be accumulated on the increased valuation should be adjusted in consolidation by eliminating the excess of the depreciation computed on the new basis over the depreciation computed on the old basis.

This excess would be eliminated by debiting *Accumulated depreciation* and crediting *Retained earnings* with the amount of the excess.

On the income statement the excess depreciation should be eliminated.

Also, the $2,000 "profit on sale of fixed assets" would be eliminated on the consolidating worksheet.

b. The eliminating entries required are:

4% bonds payable	$100,000	
Investment in S bonds		$100,000
To eliminate the intercompany holding of bonds from the balance sheet. (Some accountants prefer to show such an investment as "Treasury Bonds.")		
Interest income	3,000	
Bond interest expense		3,000
To eliminate from the income statement the intercompany interest of 4% for nine months on $100,000.		
Accrued bond interest payable	2,000	
Accrued interest receivable		2,000
To eliminate the accruals for six months from the balance sheet.		
Investment in S bonds	10,000	
Unamortized bond discount and expense		1,600
Profit on acquisition of bonds		8,160
Amortization of bond discount		240

To eliminate the proportionate part of discount from S Corporation's books and to take up the gain arising from "reacquisition" of bonds at less than carrying value. Since at the date of purchase the P Corporation might have written up investment to the amount shown on the books of S by an entry for $8,160, the entry might be for only $1,600 at this time. (NOTE: This entry assumes that P Corporation has not written up the investment but is continuing to carry it at $90,000. If amortization has been recorded, the $240 would be offset against it and the debit to *Investment in S bonds* changed by the amount of amortization taken. The net amortization would be eliminated, leaving *Profit on acquisition of bonds* unchanged.)

Solution 4

a. The question as to whether the annual or monthly rates should be used when both find support in the contract may develop into a question of the intention between the parties. However, from an accounting standpoint, good practice requires that burden charges be allocated reasonably to the work performed during a period.

In view of the parenthetical phrase pointing out that depreciation charges are not involved, it seems that the burden accounts contain chiefly costs directly associated with the performance of direct labor. Thus the contractor's position seems fair, inasmuch as the use of the rate for the entire fiscal year would, in effect, charge end-of-year supervision against first-of-year labor. The important change in the nature of the operation at the advent of the new business, of itself, calls for a reexamination and recalculation of overhead rates, and the monthly rates clearly appear more reasonable than an overall rate for this purpose.

Possible arguments for the annual rate might exist if there were a number of fixed or irregular charges which may have fallen principally into one period. Also there may be an argument for the annual rate if, because of weather or other seasonal factors, overhead normally tends to vary from one season to another.

One other possible line of argument might be the nature of the repair contract. If the contract was taken merely as a "fill-in" to keep the plant in operation, there may be some reason for considering its costs on an "average" basis rather than on a specific charge basis.

b. Direct labor hours seems to be as suitable a basis for allocation in an operation of this type as any other basis. It can be accumulated easily and is easy to verify. About the same kind of facilities are normally required for each job, and since the company seems to have only one major contract or job in process at one time, there is no serious problem of allocating overhead to different jobs during a month. Also, consideration of alternate methods does not indicate any outstanding advantages for them. Material is not uniform in relation to types of work and may be supplied in part by the government on its jobs. Direct labor dollars introduces a wage-rate element and otherwise is subject to any objections to which direct labor hours are subject. While some increased accuracy in assigning overhead to jobs might be obtained in some instances by using several divisions, departments or "cost centers," unless there are clear divisions within the yard, there does not appear to be a need for such a division of operations.

c. Several questions arise to which an answer would be desired before testifying. These are:

(1) Is overhead which is clearly attributable to the old business, such as shutdown costs, excluded from the burden accounts in the latter part of the year?

(2) Is any part of the increase simply a matter of idle time or idle equipment due to lower volume? If so, should it be charged as a contract cost?

(3) Is there normally a higher overhead rate on repair than on construction work? What does past experience indicate as to repair work?

(4) Is the rate higher than that for other yards doing repair work? If so, by how much? What explanation does the company offer?

(5) Has there been any material change in rates or salaries of supervisory and indirect labor during the last part of the year?

(6) Has there been any change in the classification of labor operations as between direct and indirect during the last part of the year?

Solution 5

a. A review of the return of the preceding year will afford clues to income and expense items that might otherwise be overlooked, particularly in the case of small taxpayers who may not have complete or well-organized records. If the taxpayer owned depreciable business property or equipment, the depreciation schedule attached to the return will give information needed in preparing the schedule for the current year's return. Dividends reported on listed stocks in the preceding year will indicate ownership of a certain number of shares of stock. Dividend income reported in the current year can be checked for correctness against a standard dividend record book. This check may indicate that additional shares have been acquired or that some have been sold. If some stock sales are discovered in this way, it would help to prevent possible oversight in reporting sales. When interest or rents have been reported on the return of the preceding year, any large deviation would provide a basis for inquiry into the reason. Partnership income, income from trusts, director's fees, gain on installment income and any of the many possible types of miscellaneous income included in the previous return would give a helpful method of avoiding omission of similar income items this year.

Expense schedules attached to the return would provide a check-list against possible omissions or incorrect listings of deductions. The list of dependents and the indication that taxpayer and spouse were or were not 65 might be helpful. However, inquiry as to changes in dependents should also be made currently. In case of operating loss or capital loss shown on the preceding year's return, the availability of the return might be a reminder of a valuable loss carry-over.

b. The client should report dividend income separately. He should be advised that failure to do this will probably cause his return to be sent out for examination, since information returns required from the various corporations will indicate that the income has been omitted. He should be told further that he is overstating his income by that method. A portion of dividend income is excludable and a deduction against tax may be taken for a portion of the dividends. Also dividends of some companies may be partially non-taxable; for example, certain corporations which derive income from the sale of natural resources. (Anaconda Copper has been a recent example.) Other examples would be liquidating dividends or dividends in some rare cases out of surplus earned before March 1, 1913. Dividends of investment mutuals usually include some long-term capital gains. Dividends on foreign stocks in most cases have been subject to withholding tax for which the U.S. taxpayer (except those using the standard deduction) is due a credit against his tax.

c. An income tax controversy may be avoided by showing in the sales contract that the sales price of merchandise is $24,000 and that $6,000 is paid for the fixtures. Since the capital gain rate applicable to the fixtures is lower, an internal revenue agent will approve the transaction more quickly if the allocation is clearly stated in the sales agreement.

d. The sale of the property would create a large income tax liability. Since the property owner does not need the cash and since the question indicates a relatively short life-expectancy, good tax planning would suggest retention of the property. Since the basis of the property will be stepped up to the fair market value at death, it can be sold then without a taxable gain.

Solution 6

a. (1)	Retained earnings	$69,450	
	Treasury stock, common (880 shares)		$40,920
	Common stock (509 shares)		25,450
	Paid-in surplus—arising from treasury stock transactions		3,080

(2) The committee has dealt with *stock split-ups* and *dividends* in the form of common stock of the corporation to its common stockholders. They stated that, although the receipt of the latter form of "dividend" is not considered to be income to the recipient, the use of the term *dividend* in this connection in announcing the intended capitalization of retained earnings probably leads many shareholders to look upon the issuance as a distribution of retained earnings. The committee believes that when the "dividend" amounts to such a small percentage (perhaps less than 20% or 25%) of the previously outstanding stock and it has no appreciable effect on the market value of the stock, an additional basis for this incorrect inference on the part of stockholders is present. The facts in the case of Tabac, Inc., meet these conditions.

The committee recommended, therefore, that in such cases it would be desirable for the corporation to transfer to "permanent capital" an appropriate portion of retained earnings. Otherwise, they pointed out, the amount of earnings which the shareholder may feel had been distributed to him would remain available for further distribution of stock or assets. The committee recommended that the amount of the transfer be equal to the fair value of the additional shares issued as a dividend, since that is the value which shareholders are likely to consider was "distributed" to them.

The action of the Tabac board is in agreement with these recommendations except for the *amount* of the transfer. The amount is improper unless the fair value based on market price over a representative period or based on other relevant factors was $50. The board's action probably was not illegal. Except for legal restrictions, such a transfer and its amount is within the board's discretion. The board may have selected par value as a basis in line with the statutory requirements of the state of incorporation, although such requirements probably would not prevent the use of a higher, reasonable basis.

(3)	Retained earnings	$88,896*	
	Treasury stock, common (880 shares)		$40,920
	Common stock (509 shares)		25,450
	Paid-in surplus—amounts contributed in excess of par value of common shares		19,446
	Paid-in surplus—arising from treasury stock transactions		3,080

*The amount transferred may be rounded off to a reasonably close approximation of fair—in this case, market—value.

b. In a case such as this, where the additional shares amount to so substantial a percentage of previously outstanding shares as materially to affect the market price of the stock, the effect is more ~~like~~ that of a *stock split-up* than of a *stock dividend,* even when called by the latter term. It *would* be a split-up, certainly, if the intent was clearly to produce a reduction in the per-share market price of the stock concerned, thereby increasing marketability and making wider distribution of shareholdings possible.

The committee suggests that where the effect and intent described above are both present, the recommendations summarized in the answer to *a*(2) do not apply, and no transfer of retained earnings (other than to meet legal requirements) is necessary.

The intent of the Tabac board cannot be determined positively from the data provided, and therefore the conformance or non-conformance of its action with this recommendation cannot be determined. The fact that they directed a transfer of retained earnings cannot be adduced with assurance in support of a statement that a stock *dividend* was intended, since such action may have been required by state law. The term "dividend" may have been used loosely.

Solution 7

a. The usual focal point of accounting is a business entity, and the cost to be accounted for is cost to that business entity. This concept places primary emphasis on accounting reports which account to owners for owners' investments and changes in their investments.

The regulatory concept of *original cost* shifts the focus. Primary emphasis is placed on the use of accounting as a basis for rate regulation. Any difference between cost and original cost is entered in an acquisition adjustment account which may be written-off over a short period of time. As a result, the accounting reports of a company show costs of other business units rather than its own costs.

b. Advocates of *original cost* in public utility accounting cite in support of their position several arguments, among which are the following:

The objective of rate regulation is to prevent excessive charges to consumers while permitting a fair return to investors. The idea that utility investors are entitled to a fair return on investment rather than a return based on the "value" of utility property has been accepted by regulatory bodies. "Value" depends on earning power and its use would trap thinking in a circle: rates would be set to yield a fair return on the "value" of utility property, and the "value" of the property would in turn be determined by the rates set.

Cost is the measurement of investment in utility property. If rates are properly determined, utility investors will earn a fair return on their investment, and consumers will pay a fair charge for service. Now assume that the property of one utility is purchased by another utility. The original cost is still the basis of a fair return to investors and a fair charge to consumers. This is true regardless of whether the second utility paid more or less than the original cost less accrued depreciation. The second utility could not prudently pay more than original cost since the value of the property was determined by rates set on the original cost.

Proponents of original cost also argue that consumers should not be charged for the cost of utility property more than once. Transfers of property between related companies may not be the result of arms-length bargaining. Inflated prices could result and the consumer could be penalized if original cost were not used.

Although it is argued that original cost is inequitable because the dollar changes in value, most investments in utilities are by bondholders and preferred stockholders. Bondholders and preferred stockholders receive a dollar return, not a return of purchasing power, in any event. Furthermore, rates are set at a level which will attract needed investment in common stock, which presumably must compensate for any long-run change in interest rate or dollar value.

Accounting reports to prospective investors probably give a better picture of future earnings when original cost is used because rates are based on original cost.

c. Opponents of *original cost* in public utility accounting have cited the following as difficulties or disadvantages:

The original-cost concept supplanted the concept that rates should be based on the fair value of property as indicated by reproduction cost less depreciation. To apply the original-cost concept retroactively was clearly inequitable. Furthermore, when added investments are not needed, rates may not be adjusted for dollar changes and common stockholders may not be adequately compensated for decreasing dollar values.

From a reporting viewpoint there are other objections. Reports to stockholders should reflect company costs, not costs of some other company.

Determination of original cost is a difficult and sometimes impossible task. Auditing of original cost is also difficult. Where this is so, the reliability of accounting statements is impaired.

Solution 8

a. Accountants act as suppliers of information for those who are interested in the financial activities of business organization. Management may prepare information in any form for internal operations, but public accountants have certain responsibilities in connection with the information distributed to corporate investors. They must keep financial reports as objective and informative as possible in order to aid investors in their appraisal of corporate activities. A continuance of the historical-cost basis of financial reporting coupled with a maximum of disclosure provides the best material for this type of financial analysis. Objectively-prepared figures and full disclosure of pertinent facts should allow individuals to make adjustments if they so desire. Other users of accounting data must either use the information provided for investors or go to management for supplemental figures. Their needs cannot be allowed to influence the reports prepared for corporate investors and must be met by special-purpose reports.

However, in reports prepared for internal use by management there is not the same need for adherence to the cost basis if data prepared on some other basis will be more useful. Management decisions are likely to be based on assumptions as to future costs, and historical data may be useful principally as a basis for projecting future costs.

b. Two very common statements prepared primarily for internal use are *budgets* and *cost statements.*

Budgets are forecasts and are used as an aid to management in planning operations and in controlling operations. They may provide data for purchasing, employment, production scheduling, sales and financing. They are not based on current financial operations and may reflect breakdowns that are useful for control, but that are not in the accounts.

Cost statements are most likely to vary from conventional statements when they are based on certain types of standards. They may show costs at ideal standard, for example, which may be considerably different from actual. They are useful to management in that they facilitate locating variations of cost from expected or ideal, and aid in the application of the "management-by-exception principle."

Solution 9

a. It is proper to charge development and experimental expenses to a deferred asset account to December 31, 1951, since there was no income to that date and since there is reason to believe that the expenditure will benefit future periods.

Therefore, there is no need to qualify the accountant's opinion in this respect. For purposes of information, it would be appropriate to footnote the balance sheet to indicate the general type of expenses capitalized and the fact that there were no income or sales during the year.

b. It seems preferable to charge the operating expenses and loss for the year 1952 to profit-and-loss and not to capitalize these items in the development and experimental deferred charge account on the balance sheet. While operations have not reached their expected volume, and there may still be some reasonable expectation of future success, the experimental and development period ended in 1951. Further, it would appear that some decision should be made prior to December 31, 1952, as to the rate of amortization or write-off of the prior year's development expense, in order that a portion thereof be charged to 1952 operations.

On the other hand, in view of the small quantity of production in 1952, management may determine not to commence amortization of the development expense until January 1, 1953. In turn, the balance-sheet footnote should indicate the decision, the reasons therefor and the period of future time over which it is estimated that the prior deferred charge will be written off. In view of the first-year experience with the product, adequate disclosure of the nature of the developmental costs shown on the balance sheet is essential. An unqualified opinion can be given except as to the treatment of the loss for the year if it is believed that the loss should not be deferred.

c. The loss for the year 1953 should be charged off to the profit-and-loss account and some amortization of the development and experimental expense account should also be charged off.

In view of the disappointingly small sales and production, there seems to be a question as to whether the new model automobile has any real commercial value. If not, it would be appropriate to charge off the greater portion of the experimental and development expense arising prior to December 31, 1953. If management is optimistic *with any good reason,* an appropriate period of amortization should be decided upon for the write-off of the prior development and experimental expense.

Unless management accepts your recommendations, you would have to qualify your opinion; or, if the company treatment makes the statements as a whole misleading, which may be the case, there should be a denial of an opinion with an explanation of the reason therefor.

Answers to Examinations, May, 1955

Accounting Practice Part I

May 18, 1955; 1:30 to 6 p.m.

Solution 1

This problem requires the solution to be submitted on a 1954 federal individual income tax return (Form 1040 including Schedule D) and such other schedules and computations as are considered necessary. Form 1040 and Schedule D are not being reproduced in the following solution but all appropriate items are listed. Each is labeled with the page, schedule and/or line number or title as shown on the official tax forms.

Page	*Schedule*	*Line*		*Total*	*Income Tax Withheld*
1.	Exemptions	1.-A.	Fred Baker		1
		1.-C.	Daniel		
			Myra		2
		1.-D.			2
					5
	Income	2.	XYZ Corp. Chicago, Ill.	$30,000	$ 4,800
			Widgets, Inc., Chicago, Ill.	12,500	1,600
			Transportation expenses	(500)	72 FICA
				$42,000	$ 6,472
		5.	Dividends, interest, etc.	7,300	
		6.	Adjusted gross income	$49,300	
			Surviving widower qualifying for special tax computation		X
	Tax due	7.	Tax		$ 8,090
		8.	Less dividends received credit	$ 160	160
		9.	Balance		$ 7,930
		12.-A.	Tax withheld	$ 6,472	
		12.-B.	Payments on estimated tax	1,000	7,472
		13.	Balance		$ 458

Do you owe any other federal tax? No

Did you pay anyone for assistance in the preparation of your return? Yes, John Jones, Chicago, Ill.

Page	*Schedule*	*Line*				
2.	A.	1.			$ 7,950	
						$7,950
	B.		$350			350
	D.	2.				(1,000)
			Total income from above sources			$ 7,300
	I.	Agnes Baker	Mother	No	All	500
		Ann Ochs	Aunt	No	1,000	2,200
			Number of individuals claimed			2
3.	Contributions		University of Chicago		$ 4,000	
			Community Chest		4,000	
			Church of Christ Building Fund		1,000	
			Miscellaneous recognized charities		3,000	$12,000
	Interest		Interest on income tax deficiency		$ 72	72
	Taxes		Sales tax		$ 200	
			Real estate taxes		910	
			License tax		25	
			Gasoline tax		15	1,150
	Medical and dental expense	1.		$700	$ 6,300	
		2.		493		
		3.			207	
		4.			$6,507	
		5.			1,479	
		6.				5,028
	Losses		Theft loss		$ 400	
						400
	Misc.		Business entertainment		$ 650	
						650
			Total deductions			$19,300
	Tax computation	1.				$49,300
		2.				19,300
		3.				$30,000
		4.				3,000
		5.				$27,000
		7. (a)			$13,500	
		(b)			4,045	
		(c)				$ 8,090
		13.				$ 8,090

Page	*Schedule*	*Line*		*A*	*B*
4.	J.	1.	DEF Company	$ 4,000	
			ABC Company		$ 4,000
		2.		$ 4,000	$ 4,000
		3.		50	
		4.		$ 3,950	$ 4,000
		5.			3,950
		6.			$ 7,950
		7. (a)			$ 160
		(b)			$ 8,090
		(c)			$ 540
		8.			$ 160

John Jones 1 N. Oak, Chicago, Ill. April 14, 1955

Schedule D

Schedule	*Line*			
D.		Fred Baker, 1234 Hemlock, Chicago 2, Illinois		
II.	3.	Debt to Don 12/15/53 7/15/54 Worthless	$ 1,000	$(1,000)
	6.			$(1,000)
	7.	MNO Company stock 1/2/45 12/31/54 Worthless	$ 5,000	$(5,000)
		Gain on sale of residence (schedule attached)		2,880
	9.			$(2,120)
				Loss
	10.			$ 1,000
	11.			2,120
	16.			$ 3,120
	17.			$ 1,000

Supporting Schedules

Transportation expenses:	
Gas, oil, depreciation, etc. (excluding gasoline tax)	$ 920
Gasoline tax	30
Vehicle taxes	50
	$ 1,000
50% for business use	$ 500
Contributions:	
Deductible under 10% limitation:	
University of Chicago	$ 4,000
Church of Christ Building Fund	1,000
	$ 5,000
10% of adjusted gross income	4,930
	$ 70
Balance to be deducted under 20% limitation	$ 70
Community Chest	4,000
Miscellaneous recognized charities	3,000
	$ 7,070
20% of adjusted gross income	9,860
*Medical and dental expense:	
Doctor, dentist and hospital bills (other than drugs) paid on behalf of:	
Fred Baker	$ 2,000
Daniel Baker	500
Myrna Baker	500
Agnes Baker	3,000
Ann Ochs	300
	$ 6,300
Sundry drugs	$ 700

*This supporting schedule contains all information given in the problem, but additional data would be necessary for complete support for the deduction.

Schedule D

Computation of gain on sale of residence:		
Sales price of residence—sold April 1, 1954	$30,000	
Real estate taxes of seller to be paid by purchaser	180	
	$30,180	
Less selling expenses	1,500	
Amount realized		$28,680
Basis of old residence—purchased in 1938		18,000
Realized gain		$10,680
Amount realized		$28,680
Fixing-up expenses		800
Adjusted sales price		$27,880
Cost of new residence—purchased June 30, 1954		25,000
Gain recognized on sale of residence		$ 2,880

Solution 2

a(1) **CAPITOL CORPORATION**

Shareholders' Equity—December 31, 1954

Capital stock:			
Class A preferred stock, $100 par value, authorized 1,000 shares—issued and outstanding 500 shares		$ 50,000	
Class B preferred stock, $100 par value, authorized and outstanding 500 shares		50,000	
No-par value common stock, authorized 50,000 shares, issued 39,500 shares of which 3,000 shares are held in the treasury*		160,500	
Total			$260,500
Surplus from revaluation of fixed assets			24,000
Premium on preferred stock (net)			2,000
Retained earnings:			
Appropriated for bond sinking fund	$ 8,000		
Appropriated for contingencies	10,000		
Appropriated for possible inventory price declines	10,000	28,000	
Unappropriated*		101,170	129,170
			$415,670
No-par value common stock reacquired—3,000 shares, at cost			15,000
			$400,670

*A dividend of 7,300 shares of common stock has been declared, payable to common shareholders of record 1/1/55.

a(2)

CAPITOL CORPORATION

Correction of Net Income—Year Ended December 31, 1954

Profit per trial balance		$125,000
Add items improperly charged:		
Increase in reserve for bond sinking fund		2,000
Creation of reserve for possible inventory price decline		10,000
Creation of reserve for preferred dividends declared		2,750
Creation of reserve for common stock dividend		7,300
Declaration of common stock dividend payable in common		7,300
Total		$154,350
Deduct items which should be charged:		
Suspense	$3,160	
Cash over and short	480	
Loss on sale of fixed assets	3,620	
Write-down of inventory to market (1954)	9,100	16,360
Corrected net income		$137,990

Analysis of Surplus Accounts—Year Ended December 31, 1954

	Retained Earnings					
Description	*Unappropriated*	*Reserve for Bond Sinking Fund*	*Reserve for Contingencies*	*Reserve for Possible Inventory Declines*	*Surplus from Revaluation of Fixed Assets*	*Premium on Preferred Stock*
Balance 1/1/54	$(22,070)	$6,000	$10,000	—	$24,000	$2,000
Changes in 1954:						
Appropriated to sinking fund	(2,000)	2,000				
Appropriated for future inventory losses	(10,000)			$10,000		
Dividend on preferred	(2,750)					
Net income for 1954	137,990					
Balance 12/31/54	$101,170	$8,000	$10,000	$10,000	$24,000	$2,000

b.

Reserve for federal income taxes is a current liability.

Reserve for loss on accounts is a valuation account and would be deducted from receivables.

Reserve for reduction of inventory to market is a valuation account and would be deducted from inventory.

Reserve for depreciation of fixed assets—cost is a valuation account and would be deducted from the related asset.

Reserve for depreciation of fixed assets—revaluation would be deducted from the related asset.

Reserve for common stock dividend to be declared does not belong on the books since dividends are not recorded until declared.

Reserve for preferred dividends declared is a current liability until paid.

Organization expense is carried as an asset until its write-off is authorized.

Bond discount and the related amortization are netted and deducted from the related long-term liability (or are shown as a deferred charge).

Solution 3

a.

P COMPANY AND SUBSIDIARY

Consolidated Statement of Retained Earnings
Year Ended December 31, 1954

Balance at beginning of year		$12,347,300.00
Net income for year		1,020,885.00
		$13,368,185.00
Deduct:		
Stock dividend—one share for each ten shares outstanding, charge equal to fair value of $15.00 a share	$1,500,000.00	
Provision for income taxes on undistributed earnings of subsidiary	48,256.26	1,548,256.26
Balance at end of year		$11,819,928.74

b.

P COMPANY AND SUBSIDIARY

Eliminating and Consolidating Entries—December 31, 1954

(1)	Capital stock—subsidiary	$200,000.00	
	Investment in subsidiary		$100,000.00
	Retained earnings		100,000.00

To eliminate the investment in capital stock of subsidiary and to restore to retained earnings the amount transferred to the capital stock of the subsidiary because of a stock dividend paid to the parent company.

(2)	Dividends received—intercompany	150,000.00	
	Retained earnings		150,000.00
	To eliminate intercompany cash dividends paid		
(3)	Retained earnings (consolidated)	48,256.26	
	Reserve for income taxes on undistributed earnings of subsidiary		48,256.26

To set up out of consolidated retained earnings the estimated amount of income taxes that would be paid if the earnings of the subsidiary were distributed to the parent company.

Correcting Entry
(Parent's Books)
(Not Required)

Accumulated depreciation	$1,143,350.00	
Deferred income taxes		$594,542.00
Net income		548,808.00

To adjust the books of P for excess depreciation and to provide for the deferment of taxes on excess amortization.

c.

P COMPANY AND SUBSIDIARY

Footnote to Balance Sheet

Dividend restrictions:

The indenture relating to the long-term debt provides that cash dividends cannot be paid out of retained earnings applicable to P Company that was accumulated at December 31, 1954. The amount so restricted was $11,149,515.

Included in consolidated retained earnings at December 31, 1954 is the amount of $100,000 that is included in the capital stock account of the subsidiary due to a stock dividend issued during the year. This amount is not available for the payment of dividends by the subsidiary.

P COMPANY AND SUBSIDIARY

Worksheet
(Not Required)

	Income Account		
	Parent	*Subsidiary*	*Consolidated*
Income—per books	$ 487,537	$134,540	$ 622,077
Excess depreciation	1,143,350	—	1,143,350
Deferred income taxes on excess depreciation	(594,542)		(594,542) (1)
Cash dividends—intercompany	(150,000)		(150,000)
Adjusted net income	$ 886,345	$134,540	$1,020,885

	Retained Earnings		
	Parent	*Subsidiary*	*Consolidated*
Retained earnings 12/31/53	$11,613,170	$734,130	$12,347,300.00
Cash dividends—intercompany	150,000	(150,000)	
Adjusted net income	886,345	134,540	1,020,885.00
Stock dividend—parent	(1,500,000)		(1,500,000.00)
	$11,149,515	$718,670	$11,868,185.00
Provision for income taxes on undistributed earnings			48,256.26(2)
Consolidated retained earnings 12/31/54			$11,819,928.74

(1) Computation of Deferred Taxes

$1,143,350	
52%	Tax rate
$ 594,542	

(2) Computation of Income Taxes on Undistributed Earnings

Retained earnings of subsidiary	$718,670.00
Less capitalized amount	100,000.00
	$618,670.00
% exempt for income tax purposes	85%
	$525,869.50
Amount subject to income taxes	$ 92,800.50
Tax rate	52%
Amount of tax	$ 48,256.26

Solution 4

a. Present value of annuity of 1 for 20 periods @ 2½% = 15.5892
Amount of principal of notes is \$40,000
\$40,000 divided by 15.5892 = \$2,566, face of each note

b. Jones' plan consists of accumulation of a fund and the subsequent withdrawal of an annuity. Accumulation of the fund is computed as follows:
Amount of payments of 1 for 20 periods with 3% interest = 26.8704
Amount of each payment is \$500
\$500 × 26.8704 = \$13,435.20, amount of fund
Withdrawals from fund for 30 periods are computed as:
Present value of annuity of 1 for 30 periods @ 3% = 19.6004
Amount of semiannual payments: \$13,435.20 divided by 19.6004 = \$685

c. (1) The company must borrow an additional \$150,000 to carry out the refinancing, so this becomes a "cost" of the refinancing. In addition to that cost the company must pay 2% interest on the bonds for 20 periods. The total cost of refinancing is the sum of these two elements.

If refinancing is not carried out, the company must pay interest at 2½% on \$2,000,000 of bonds for 20 periods.

To compare the two plans, the costs can be reduced to their present values based on the current rate of interest which the company must pay. The computations are:

(a) Present value of 1 at 2% for 20 periods = .67297. \$150,000 × .67297 = \$100,945, present value of the extra amount borrowed

(b) Interest cost if refinanced: \$2,150,000 @ 2% = \$43,000 for 20 periods
Present value of annuity of 1 @ 2% for 20 periods = 16.3514
\$43,000 × 16.3514 = \$703,110, present value of series of interest if refinanced

(c) Total cost of refinancing:

Cost of \$150,000 borrowed	\$100,945
Cost of interest series	703,110
Total present value	\$804,055

(d) Interest cost if not refinanced is \$50,000 for 20 periods
Present value of annuity of 1 @ 2% for 20 periods = 16.3514
\$50,000 × 16.3514 = \$817,570, present value of series of interest costs if not refinanced

(e)

Cost if not refinanced	\$817,570
Cost if refinanced	804,055
Saving on refinancing	\$ 13,515

(2) The three treatments most frequently advanced for the disposition of the unamortized portion of discount and expense pertaining to bonds refunded are:

(a) A direct write-off to income or retained earnings in the year in which refunding takes place.
Argument: The unamortized discount and expense of the refunded bonds is a cost of terminating the contract, the terms of which are now disadvantageous. Losses or expenses should be recognized not later than the completion of the transactions which gave rise to them.

(b) Amortization over the remainder of the original life of the refunded (old) issue.
Argument: The discount arising at time of issue is part of the cost of acquiring an option to terminate the bond contract before maturity and is properly part of the cost of borrowing over the entire period of the original issue, particularly when the saving achieved through refinancing is greater for the unexpired term of the old bonds than the amount of unamortized discount on the old bonds. Since the discount ("cost of option") is part of the cost of the saving achieved by refinancing for the unexpired term of the old issue, the doctrine that costs should be charged against the periods in which the benefits are realized applies.

(c) Amortization over the life of the new issue.
Argument: The expense of retiring the old issue is part of the cost of the new transaction and, as such, should be charged against all periods benefited under the new issue.

(A compromise between (a) and (b) has also been suggested as acceptable treatment: amortization over a period shorter than the unexpired term of the old bonds, provided that the charge is made against income and is not in any year so large as seriously to distort income for that year.)

Accounting Practice—Part II

May 19, 1955; 1:30 to 6 p.m.

Solution 1

There is more than one feasible method of recording the transactions in a situation of this kind. It is essential that accounts be kept in such a manner that the equity of the company in the assigned accounts will be readily determinable and that the amount due to the finance company is determinable. One such method for recording the transactions follows.

a. **CUTLASS DRESS MANUFACTURING CORPORATION**

Transactions—April, 1955

As Transactions Were Recorded

Date		*Cash*	*Accounts Receivable*	*Suspense*	*Sales*
April	1	$6,850	$(10,000)	$3,150	
	2		4,000		$(4,000)
	10	200		(200)	
	15	900	(900)		
	18	(1,050)	1,050		
	20	900		(900)	
	30				
	30				
Total		$7,800	$(5,850)	$2,050	$(4,000)

b. **Adjusting Journal Entry**

Accounts receivable	$1,250.00	
Equity in assigned accounts	900.00	
Due from finance company	477.67	
Sales	2,000.00	
Selling expense	200.00	
Interest and finance charges	222.33	
Suspense		$ 2,050.00
Accounts receivable assigned		3,000.00

c. **Balance-Sheet Presentation**

Accounts receivable—trade	$28,250.00
Due from finance company on collected accounts	477.67
Equity in $3,000 of assigned accounts	900.00
	$29,627.67

Note: The accounts-receivable amount is computed as follows:

Client's balance—4/30	$30,000.00
Audit adjustments	1,250.00
Adjusted balance—4/30	$31,250.00
Assigned accounts receivable—per audit, 4/30	3,000.00
	$28,250.00

As Transactions Should Have Been Recorded

Date	Suspense	Cash	Accounts Receivable	Accounts Receivable Assigned	Equity in Assigned Accounts	Due from Finance Company	Sales	Selling Expense	Interest and Finance Charges	Memo of Consigned Inventory
1		$6,850		$(10,000)	$3,000				$150.00	
2										$4,000
10		200	$(1,000)	1,000	(300)	$100.00				
15		900					$(1,000)	$100		(1,000)
18		(1,050)		1,500	(450)					
20		900	(4,500)	4,500	(1,350)	450.00				
30			900				(1,000)	100		(1,000)
30						(72.33)*			72.33*	
	—	$7,800	$(4,600)	$(3,000)	$ 900	$477.67	$(2,000)	$200	$222.33	$2,000
Amount recorded	$ 2,050	7,800	(5,850)	—	—	—	(4,000)	—	—	
AJ.E.	$(2,050)	—	$ 1,250	$(3,000)	$ 900	$477.67	$ 2,000	$200	$222.33	

* Calculation of Interest Expense

Account	Amount	Number of Days Outstanding	Interest
A	$1,000	10	$ 3.33
B	1,500	18	9.00
C	2,000	20	13.33
D	2,500	20	16.67
E	3,000	30	30.00
Total			$72.33

Solution 2

THE TRUMB RADIO CORPORATION
Computation of Reserve for Product Warranty—June 30, 1954

		Total Estimated Sales Returns		*Estimated Returns Not Received by 6/30/54*	
Month	*Sales Volume*	*%*	*Amount*	*%*	*Amount*
January	$ 3,600,000	8	$ 288,000	10	$ 28,800
February	3,300,000	8	264,000	20	52,800
March	4,100,000	8	328,000	30	98,400
April	2,850,000	8	228,000	50	114,000
May	2,000,000	10	200,000	80	160,000
June	1,800,000	10	180,000	100	180,000
	$17,650,000		$1,488,000		$634,000

Estimated returns at selling price		$634,000
Estimated freight on returns (10% of selling price)		63,400
		$697,400
Deductions:		
Gross margin of sales over cost of goods sold (20% of selling price)	$126,800	
Salvage recovery (15% of selling price)	95,100	221,900
Estimated reserve needed		$475,500
Balance in reserve account		80,250
Estimated provision needed 6/30/54		$395,250

Journal Entry

Provision for product warranty	$395,250	
Reserve for product warranty		$395,250

From the data given, it seems that the company has charged to expense as incurred the actual cost to June 30, of making good on 1954 warranties. The provision of $395,250 is based on that interpretation. However, if the company charged such warranty costs to the reserve account, the provision would be increased by the amount of the actual costs. The closing reserve would still be $475,500.

Solution 3

a. **DOMBY DISTILLERIES, INC.**

(1) The 80 per cent clause requires that the total insurance which should be carried to be "fully insured" must be 80 per cent of the fair value of the property insured at date of fire.

Formula for determining the amounts to be recovered is:

$$\frac{\text{Amount of insurance}}{80\%\text{ of fair value}} \times \text{Loss} = \text{Recovery, unless greater than face of policy}$$

Applying this formula in this case we have:

$$\frac{\$200{,}000}{\$208{,}000} \times \$255{,}000 = \$245{,}192.$$

Since this is in excess of the face of the policies, the recovery would be the face amount of each policy, with a claim of $80,000 against X and a claim of $120,000 against Y.

(2) *Computation of fire loss account balance*:

Charges:	
Book value of building destroyed	$160,000
Unexpired insurance from 7/1/54:	
Co. X 2/8 × $ 800	200
Y 2/8 × 1,200	300
	$160,500
Credit:	
Proceeds from insurance companies	$200,000
Account balance, before other transactions	$(39,500) Cr.

b.

(1) (a) Instead of reporting the entire gain for federal income taxation purposes, the taxpayer may elect (under Sec. 1033, IRC 1954) to recognize the gain only to the extent that the amount realized in the involuntary conversion exceeds the cost of the replacing property.

(b) Cost basis of new (replacing) property for federal income taxation purposes would be the total cost of acquisition of such new property less the *untaxed* portion of the "gain" on conversion.

(Sec. 1033, IRC 1954 states that, for such property, the ". . . basis shall be same as in the case of the property so converted, decreased in the amount of any money received by the taxpayer which was not expended in accordance with the provisions of law . . . determining the taxable status of the gain or loss on such conversion, and increased in the amount of gain or decreased in the amount of loss to the taxpayer recognized upon such conversion. . . ." It goes on to specify that, in the case of similar property purchased by the taxpayer as a replacement for that involuntarily converted, if the transaction "... resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized. . . .")

(c) Cost basis of new (replacing) property for accounting purposes would be the total cost of acquisition of the property.

(2)

	Recognized Gain	*Federal Income Tax Basis*	*Accounting Basis*
(a)	$40,000	$100,000	$100,000
(b)	10,000	110,000	140,000
(c)	None	150,000	190,000

Solution 4

a.

Appraisal of current budget procedure:

1. By applying a flat percentage (115 per cent) to direct labor cost in absorbing all overhead, the firm is treating the fixed elements of overhead as though they were variable.
2. The use of direct labor cost as a basis for overhead absorption is subject to the usual criticisms that it:
   a. Does not consider the contribution of other factors of production such as machinery.
   b. Gives dollar weights to such items as depreciation which is more a function of time.
   c. Penalizes work performed by highly paid operators in relation to the same work done by low-rate workers.
3. A direct labor cost basis does have the merits of (a) being easy to use and (b) recognizing those elements of overhead which tend to vary directly with direct labor rates.

b. Computation of Absorption Rate—Percentage of Direct Labor Cost

	Budgeted Overhead	*Budgeted Direct Labor*	*Budgeted Absorption Rate*
Fixed	$ 57,936	$163,200	35.5%
Variable	129,744	163,200	79.5%
Total	$187,680	$163,200	115.0%

Underabsorption of Overhead—Fixed and Variable

	Actual Labor Cost	*Rate*	*Absorbed Amount*	*Actual Cost*	*Under-absorbed*
Fixed	$183,040	35.5	$ 64,979.20	$ 75,400	$10,420.80
Variable	183,040	79.5	145,516.80	145,600	83.20
Total	$183,040	115.0	$210,496.00	$221,000	$10,504.00

Computation of Absorption Rate—Dollars per Direct Labor Hour

	Budgeted Overhead	*Budgeted Direct Labor Hours*	*Budgeted Absorption Rate*
Fixed	$ 57,936	136,000	$ .426
Variable	129,744	136,000	.954
Total	$187,680	136,000	$1.380

Analysis of Difference in Labor Cost

	Hours	*Rate*	*Amount*
Actual	130,000	$1.408	$183,040
Budget	136,000	1.200	163,200
Difference	(6,000)	$ .208	$ 19,840

Analysis of Underabsorption

	Fixed	*Variable*	*Total*
Due to Hours of Operation:			
Number of hours under budget	(6,000)	(6,000)	(6,000)
Budgeted rate per hour	$ .426	$ .954	$ 1.38
Underabsorption due to hours	$(2,556)	$(5,724)	$(8,280)
Due to Higher Labor Rate:			
Labor rate over budget	$ .208	$ .208	$ .208
Actual labor hours	130,000	130,000	130,000
Excess labor cost due to rate	$27,040	$27,040	$27,040
Absorption rate	35.5	79.5	1.15
Overabsorption due to labor rate	$ 9,599	$21,497	$31,096
Net over or (under) absorption of budget	$ 7,043	$15,773	$22,816
Variation between overhead budget and actual amount spent	(17,464)	(15,856)	33,320
Net	$(10,421)	$(83)	$(10,504)

Explanatory Comments

The $10,504 underabsorption of overhead is due to a combination of two factors:

1. Operating 6,000 direct labor hours (136,000 hours, budget—130,000 hours, actual) less than expected.
2. The increase in the direct labor rate from $1.20 to $1.408.

The budget provides for the absorption of overhead at a rate of 115 per cent of direct labor cost. Broken down into the variable and fixed elements, the rate is 79.5 per cent and 35.5 per cent, respectively.

On a dollar basis, this amounts to 95.4¢ per direct labor hour for variable and 42.6¢ per direct labor hour for fixed.

Operating 6,000 direct labor hours less than expected caused the variable portion of the budget to be underabsorbed by $5,724 (6,000 hours @ 95.4¢ per hour). The fixed overhead budget was underabsorbed by $2,556 (6,000 hours @ 42.6¢).

The absorption of overhead at a percentage of direct labor cost means that the direct labor rate will have a decided effect on the amount of overhead absorbed. The company operated 130,000 direct labor hours at $1.408 per hour instead of the budgeted rate of $1.20. Since overhead was absorbed at 115 per cent of direct labor cost the increase in direct labor rate of $0.208 caused the budget to be overabsorbed by $31,096 (130,000 hours @ $0.208 × 115 per cent). The overabsorption of budget due to variable burden is $21,497; the amount due to fixed overhead is $9,599.

The net overabsorption of the budget for both variable and fixed is as follows:

	Variable	*Fixed*	*Total*
Underabsorption due to operating 6,000 hours less than expected	$ 5,724	$ 2,556	$ 8,280
Overabsorption due to increase in direct labor rate of $0.208	21,497	9,599	31,096
Net overabsorption of budget	$ 15,773	$ 7,043	$ 22,816

The variation of actual from budget was as follows:

	Variable	*Fixed*	*Total*
Actual	$145,600	$75,400	$221,000
Budget	129,744	57,936	187,680
Overspending of budget	$ 15,856	$17,464	$ 33,320

A comparison of our absorption of budget with overspending of the budget follows:

	Variable	*Fixed*	*Total*
Overspending of budget	$ 15,856	$17,464	$ 33,320
Overabsorption of budget	15,773	7,043	22,816
Net underabsorption of actual	$ 83	$10,421	$ 10,504

The variable portion of the budget shows a net underabsorption of actual of only $83. In the case of fixed overhead, however, the net underabsorption was $10,421.

While the method used to absorb overhead treats fixed overhead the same as variable, and therefore would tend to produce overabsorption of fixed overhead when total labor cost rose, fixed was in fact underabsorbed. Fixed overhead did not stay fixed but rose even faster than variable. Variable overhead did vary closely with labor cost as evidenced by almost complete absorption of it.

It is not possible to explain this overspending of fixed overhead on the basis of the information given. Some of the increase might be due to poor control of the items making up fixed cost. A part might be due to low estimates in making up the budget. Another possibility is that the company has increased fixed charges by expansion of plant capacity which is not yet being used.

Solution 5 *a.*

X STEEL COMPANY

Statement of the Composition of Eureka-Bessemer Lifo Pools and Cost of Ore Used for the Years Ended December 31, 1949 to 1954, Inclusive

Year Ended Dec. 31		Composition of Lifo Pools: Yearly Layers	Tons	Unit Cost	Amount	Cost of Ore Used, Composition of Layers in Computation: Yearly Layers	Tons	Unit Cost	Amount
1949	(1)	Base ('47 & '48)	5,000	$ 6.60	$ 33,000				
		1949 increment	1,000	9.00	9,000				
			6,000		$ 42,000				
1950		Base	5,000	$ 6.60	$ 33,000	1950	5,500	$ 9.00	$ 49,500
		1949 increment	1,000	9.00	9,000				
	(2)	1950 increment	500	9.00	4,500				
			6,500		$ 46,500		5,500		$ 49,500
1951		Base	5,000	$ 6.60	$ 33,000	1951	8,000	$10.00	$ 80,000
		1949 increment	1,000	9.00	9,000				
	(2)	1950 increment	500	9.00	4,500				
	(2)	1951 increment	4,000	10.00	40,000				
			10,500		$ 86,500		8,000		$ 80,000
1952		Base	5,000	$ 6.60	$ 33,000	1952	10,000	$11.25	$112,500
		1949 increment	1,000	9.00	9,000				
	(3)	1950 increment	1,000	9.50	9,500				
	(3)	1951 increment	5,000	10.20	51,000				
	(3)	1952 increment	2,000	11.25	22,500				
			14,000		$125,000		10,000		$112,500
1953		Base	3,500	$ 6.60	$ 23,100	1953	6,000	$12.00	$ 72,000
						1952	2,000	11.25	22,500
						1951	5,000	10.20	51,000
						1950	1,000	9.50	9,500
						1949	1,000	9.00	9,000
						Base	1,500	6.60	9,900
			3,500		$ 23,100		16,500		$173,900
1954		Base	3,500	$ 6.60	$ 23,100	1954	2,000	$11.00	$ 22,000
		1954 increment	1,000	11.00	11,000				
			4,500		$ 34,100		2,000		$ 22,000

(1) See Schedule I for computation of the base-year pool.
(2) In addition to the inventory shown, Y Company had quantities of this ore valued under lifo in 1950 and 1951, which were recorded in separate lifo pools until December 31, 1952.
(3) See Schedule II for calculation of layers merged upon acquisition of Company Y's inventory.

X STEEL COMPANY

Schedule I
Computation of Base-Year Pool

Year	*Tons*	*Unit Cost*	*Amount*
1947	2,000	$6.00 (1)	$12,000
1948	3,000	7.00 (1)	21,000
	5,000	$6.60	$33,000

(1) Cost value restored for purpose of lifo valuation.

Schedule II

Calculation of Layers Merged upon Merger with Company Y

Works	*Layers*	*Tons*	*Unit Cost*	*Amount*
East	1950	500	$ 9.00	$ 4,500
North (Y Co.)	1950	500	10.00	5,000
		1,000	$ 9.50	$ 9,500
East	1951	4,000	$10.00	$ 40,000
North (Y Co.)	1951	1,000	11.00	11,000
		5,000	$10.20	$ 51,000
East	1952	9,000	$11.00	$ 99,000
North (Y Co.)	1952	3,000	12.00	36,000
		12,000	$11.25	$135,000

b.

Board of Directors
X Steel Company (*Date*)
Dear Sirs:

In accordance with your instructions, I have prepared a statement of the composition of Eureka-Bessemer lifo pools and cost of ore used for years ended December 31, 1949 to 1954, inclusive. The statement and supporting schedules are submitted together with my comments.

Comments on specific points involved in the statement preparation follow:

1. The election to adopt lifo method of valuation was made for the year ended December 31, 1949. Therefore, the base period is represented by the inventory on hand at January 1, 1949.
2. For tax purposes, lifo inventories must be stated at cost; therefore, the write-downs to market affecting the 1947 and 1948 inventories must be restored.
3. The 1947 and 1948 acquisitions are grouped into one pool as the base year, and for lifo purposes they are considered to have been purchased at one time. Their grouped cost is determined by the average cost method.

4. The parent company was not required to merge the lifo pools of the Y Company until December 31, 1952. At that time, the existing pools were merged, layer upon layer, for the respective years, with the cost per layer computed by the average cost method.
5. The decline in market value of the ore at December 31, 1954 is not given effect in this calculation because, for tax reporting purposes, lifo inventories are computed at cost.

As agreed upon in our discussions, these calculations have been made from the records of the company as presented to me by company personnel and have not been audited. Therefore, I cannot give an opinion as to whether the inventory values and cost of ore used in the statement and schedules have been presented fairly.

Yours very truly,

Auditing

May 19, 1955; 9 a.m. to 12:30 p.m.

Solution 1

a. (1) A contingent liability may be defined as a possible liability arising from past circumstances or actions. It may, or may not, become an actual obligation in the future. The exact amount may, or may not, be determinable at present.

(2) Contingent liabilities may be reflected in the statements by any of the following methods:

(a) Described in a footnote to the financial statements.

(b) Extended "short" in the balance sheet between Liabilities and Proprietorship.

(c) On assets which are pledged or discounted, the gross asset may be shown and a deduction made, extending the asset "net" of the contingent amount.

(d) Reflect as an appropriation of Retained earnings.

The trend at the present time appears to favor showing "Contingent liabilities" as footnotes to the financial statements, thereby leaving the balance sheet clear of obligations which are not certain at the balance-sheet date. However, many companies appropriate Retained earnings for certain types of contingencies.

b. (1) If payment by Newart is uncertain, the $3,750 interest liability for the period June 2 through December 1, 1954 could be reflected in the Marco Corporation's accounting records by the following entry:

Interest Payments for Newart Company $3,750
  Accrued Interest Payable—Newart Bonds $3,750

The debit entry should be included as Other assets. Collection is uncertain and the Marco Corporation may not have a right against the Newart Company until all interest payments have been met and the bonds retired. If this treatment is followed, the balance sheet should be footnoted to the effect that the Marco Corporation is contingently liable for future interest payments on Newart Company Bonds in the amount of $60,000.

If the interest has been paid by the time the audit is completed, or if for other reasons it seems certain that the payment will be made by Newart on January 15, no entry should be made by Marco. In this circumstance a footnote disclosing the contingent liability of $63,750 and the facts as to the $3,750 should be included with the statements.

(2) The lawsuit should be described in a footnote to the balance sheet. In view of the court decision, retained earnings may be restricted for $40,000, the amount of the first court decision. Also in view of the court decision, any reasonable estimate of the amount the company expects to pay as a result of the suit might be used in lieu of the $40,000. A current liability will be set up as soon as a final decision is rendered or if an agreement as to damages is reached. If liability is admitted by Marco, and only the amount is in dispute, a liability can be set up now for the amount admitted by the company, with a corresponding charge to expense or to Retained earnings if the amount is material.

(3) The declaration of such a dividend does not create a liability which affects the aggregate net worth in any way. The distribution of the dividend will cause a reduction in retained earnings and an increase in capital stock. No entry is necessary, but an indication of the action taken, and that such a transfer will subsequently be made, should be shown as a footnote or as a memorandum to Retained earnings and Common stock in the balance sheet.

Solution 2

a. It is obvious from the comments made in the letter from the corporation's president that he is not fully informed on the extent and scope of a "certified" audit. This will require:

1. Arranging a conference with the president of the corporation to review:
   (a) The meaning of the accountant's opinion, including an explanation of an unqualified opinion and of a qualified opinion.
   (b) The report with opinion denied.
   (c) Statements prepared without audit.
   (d) The required audit procedure to satisfy the bank's request.
   (e) The extent of the fee as compared to the fee for prior years' tax work.
2. Reviewing staff schedules to be sure that the work can be handled within the time available.
3. Arranging with the corporation to obtain the assistance of employees in preparing schedules, trial balances, etc.
4. Reviewing the terms of the loan agreement and possibly arranging a conference with the bank.

b. It is assumed that the bank requires an unqualified opinion on the financial statements, which assumption is based upon the size of the loan and other information which a bank will normally expect from a "certified" audit. The general procedure to be followed will include the following steps:

1. Preparation of a complete audit program.
2. Performance of preliminary detail audit work prior to December 31 to include:
   (a) Review of existing internal control
   (b) Examination of minute records, corporation organization papers, deeds, capital stock records, mortgages, etc.

(c) Examination by sufficient test of the entries, documents, etc., recorded in the:
  (1) Cash receipts journal
  (2) Check register
  (3) Voucher or purchase journal
  (4) Sales journal
  (5) Payroll journal
  (6) General journal
  (7) Accounts receivable ledger
(d) Prepare trial balance forms.
(e) Analyze the basis and entries in the following balance-sheet accounts:
  (1) Fixed assets since inception of the company
  (2) Prepaid expenses
  (3) Real and personal property taxes
  (4) Notes and mortgages payable
  (5) Payroll taxes and deductions
  (6) Capital accounts (stock, retained earnings) since inception
(f) Review status of prepaid and accrued accounts at beginning of year.
(g) Search for unrecorded liabilities as of the first of the year.
(h) Review and make tests of opening inventory.
(i) Check sales and purchase cut-off at first of year.
(j) Analyze expense and sundry income accounts which appear to contain unusual balances in relation to the scope of the business.

3. Organize the following program for the last day of the year:
  (a) Count all cash and change funds on hand in the store.
  (b) Examine securities, notes receivable, etc.
  (c) Prepare and mail bank confirmation letters.
  (d) Observe taking of the physical inventory and make necessary tests.
4. At the time the trial balance is furnished perform the following:
  (a) Complete the account analysis workpapers which were started during the preliminary work.
  (b) Determine and audit the detail of all liabilities.
  (c) Send out confirmation requests on customers' balances.
  (d) Confirm sufficient outstanding payables to satisfy that amounts are properly recorded.
  (e) Complete work on inventory, including pricing, clerical accuracy and condition.
  (f) Determine that sales and purchases were recorded in the proper period at the close of the year.
  (g) Reconcile all confirmation letters to final trial balance.
  (h) Determine income tax liability.
  (i) Search for unrecorded liabilities at end of year.
5. Review working papers and completed audit procedures. The work should be completely reviewed by the principal before the staff has left the client's office.

6. Make gross profit test and other overall comparisons. Prepare auditor's report to include:
   (a) Balance sheet
   (b) Statement of income
   (c) Analysis of earnings retained in the business
   (d) Supporting exhibits and schedules where appropriate
   (e) Auditor's opinion, including qualifications, if necessary (A qualification as to profit and loss may be necessary in this case.)
   (f) If the engagement warrants, comments with schedules which further explain the financial position of the company will enhance the report.

Solution 3

The procedure followed appears to be appropriate except that the examination of detail transactions for three months might be considered to be excessive in view of the exceptionally good internal control. A lighter test of such transactions, designed to test the efficiency of the established system, might be devised.

The procedures followed should be supplemented by the following:

1. Review the company's method of sales cut-off at year-end and test billings and shipments (including returns) for an adequate period before and after year-end to establish that cut-off procedures have been adhered to.
2. Examine collections in early part of subsequent period to determine if a substantial portion of the receivables has been collected.
3. Examine agreements entered into with the distributors. If price protection clauses are included, review the current price position and distributor inventory positions to determine whether a reserve for such protection is needed.
4. When a company deals with a limited number of customers it is dependent upon the continued solvency of *all* such customers. This is different from the usual situation involving large numbers of customers where the insolvency of a few is of little significance in relation to the overall financial position. Discuss this situation with the credit manager, reviewing credit limits allowed and current credit terms granted. Verify credit ratings provided by reputable credit services. Obtain recent financial statements of all 20 customers. The provision for doubtful accounts should be evaluated in the light of the findings.
5. Obtain a representation letter from appropriate company officials covering the receivables.

Solution 4

a. No. Rule No. 11, Rules of Professional Conduct, states: "A member shall not be an officer, director, stockholder, representative or agent of a corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia."

b. No. This is construed as advertising his professional attainments, and involves indirect solicitation.

c. No. Rule No. 5, Rules of Professional Conduct, states: "In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if: . . . (c) He is grossly negligent in the conduct of his examination or in making the report thereon; or (d) He fails to acquire sufficient information to warrant expression of an opinion. . . ." Jensen has failed to acquire such information.

d. No. Rule No. 5, Rules of Professional Conduct, states: "In expressing an opinion on representations in financial statements which he has examined, a member may be held guilty of an act discreditable to the profession if: (b) He fails to report any material misstatement known to him to appear in the financial statement." Also see (c) above. The statement as presented would be expected to mislead.

e. Yes. Employees who are qualified and adequately supervised may be used for examinations of statements. (Rule No. 2.)

f. Yes. A reasonably sized notice of affiliation is acceptable. (Rule No. 10.)

g. No. Rule No. 14, Rules of Professional Conduct, provides that a member shall not make a competitive bid for a professional engagement in any state, territory, or District of Columbia, if such bid is a violation of the rules of the accounting governing body within that political division. The rule does not provide for an exception on the basis of requests for bids. However, whether there is an absolute prohibition against competitive bids depends upon the existence of a state rule.

Solution 5

a. The purpose of an internal control system is to provide, within the framework of an organization's office and accounting system, methods to safeguard its assets, check the accuracy and reliability of its accounting data, protect against improper disbursements of cash, and promote efficiency in management and adherence to managerial policies.

The effective operation of an internal control system is dependent upon two main factors. First, a well-planned set of accounting records must be kept and strict executive supervision thereof maintained. Second, an appropriate division of work and a clear segregation of duties and responsibilities between office employees must be made to be sure that no one individual has complete control of an entire cycle of work. Of course, if the number of office personnel required is small, the possibilities of dividing the work and segregating duties for obtaining effective control are limited. This can be overcome to a certain extent by the day-to-day observations of the owners or executives of the organization. In fact, it is absolutely necessary that any system of internal control must be under constant supervision of the management or have periodic auditing by independent accountants to ascertain whether the procedures designed for the organization are being carefully followed.

As mentioned above, a good internal control system not only helps prevent loss of assets through fraud or embezzlement, but actually can increase profits by reducing accounting errors and controlling inefficiency due to lack of proper policies.

For instance, in connection with merchandise sales or purchases, procedures should include checking of quantities, prices and extensions of invoices. Where possible, perpetual inventories should be maintained. In any case, however, periodic physical inventories should be taken. A property ledger, showing the detail items of fixed assets owned by an organization, should be kept to maintain control of ownership, disposition or abandonment of equipment, etc.

b. There are several control measures which may be employed *by a small business with too few office employees to permit an adequate separation of duties* for purposes of internal control. Some of the most feasible are:

(1) Use of double-entry bookkeeping and of such proof techniques as trial balances, bank reconciliations and control accounts for customers and creditors.
(2) Use of mechanical devices such as cash registers (which the owner reads daily and to which he retains the keys) and check protectors.
(3) Insistence that cash receipts be deposited intact daily and that duplicate deposit tickets be secured.
(4) Making of all disbursements except those for petty cash by check, properly supported by invoices or other documents.
(5) Use of an imprest fund with signed and descriptive receipts for all expenditures, which receipts the owner inspects at time of reimbursement.
(6) Bonding of employees.
(7) Insistence that employees take periodic vacations.
(8) Use of serially prenumbered checks, sales invoices, purchase orders, and receiving reports, and accounting for all blank and voided forms.
(9) Use of periodic physical inventories.
(10) Preparation and mailing of monthly statements to customers. It would be well for the owner occasionally to compare sales tickets and monthly statements with the individual ledger accounts and occasionally to mail monthly statements personally.

The owner-manager can contribute effectively to internal control by:

(11) Maintaining good hiring and personnel policies.
(12) Receiving and opening all mail, making notes of remittances for comparison with duplicate deposit tickets.
(13) Preparing or at least reviewing bank reconciliations.
(14) Signing all checks personally and inspecting supporting documents for each check. He should systematically indicate payment on each such document when he signs the check, so that the document may not be used again to support another check.
(15) Requiring the preparation of monthly statements (preferably in comparative form) and reviewing them intelligently in the light of his intimate knowledge of operations. Where feasible, he should require and review at more frequent intervals statistical reports of units sold, produced, purchased and on hand.

(16) Requiring that all credit adjustments, bad debt write-offs and all general journal entries receive his written approval.

(17) Retaining a certified public accountant for annual and interim audit work.

Solution 6

a. The following company procedures should be required:

(1) Written inventory instructions should be prepared and applied uniformly in the twenty stores. The home-office representative should see that these instructions are followed in taking the physical inventories.

(2) An appropriate cut-off of goods in transit should be established for each store, including goods sold but not yet delivered. Consigned merchandise, if any, should be excluded from the inventory.

(3) The items of merchandise should be segregated by types to facilitate an accurate count, and inventory slips or tags should be used where necessary.

(4) All items of merchandise, including those with "no value," should be listed on prenumbered inventory sheets showing a description of the item, the quantity on hand, the marked unit cost and the unit price which in the opinion of the store manager would enable him to move the quantity on hand within a reasonable time at a sales price which would yield a fair margin of gross profit.

(5) The representative of the head office should make tests of the quantities and the unit prices, control the inventory sheets, and return them to the home office.

(6) A designated person in the head office who is acquainted with the merchandise should review the inventory sheets for each store, making such adjustments in the unit prices as appear to be justified by the circumstances.

(7) The inventory sheets should be extended, added, and summarized in the head office.

(8) The practice of reducing the store inventory by the over-all percentage would be discontinued.

(9) Inventory sheets would be kept for a reasonable time, or at the very least until tax returns for the year had been examined or the statutory period had run.

b. The general program should include:

(1) The auditor should review the company's inventory instructions and see that they are being uniformly applied.

(2) The auditor should be present at all or at least a representative number of stores at the time inventories are being taken to observe procedures. He should test quantities and marked prices and discuss with the store manager any suggested markdown that would materially affect the inventory. He should make tests of obsolete and other no-value merchandise.

(3) The auditor should make such test checks of the clerical accuracy and prices of the inventory as he believes to be necessary in order to satisfy himself that the inventory is fairly stated. Prices should be tested by comparison with recent purchase invoices and explanations should be obtained in the case of substantial variations. The extent of these tests should be determined by taking

into consideration the number of items and the individual amounts making up the total inventory and the fact that a change in inventory policy had been adopted would justify more extensive tests in the first year.

(4) Tests to determine the accuracy of the cut-off should be made.

(5) The inventory sheets should be tied into summaries and into the ledger in total.

(6) Gross profit tests by stores or similar over-all tests of the reasonableness of inventories should be made.

c. If all the requirements as to changes in company procedures were agreed to, it would still be necessary for the auditor to qualify his opinion with respect to the opening inventory used in the profit-and-loss statement. It would be impossible for him to satisfy himself with respect to that item and its possible effect on profits for the year.

In the event the proposals outlined in *a* above were not agreed to in substance, the auditor, if he accepts the engagement at all, should do so with the understanding that he would disclaim an opinion on the financial statements. This is not a circumstance in which a qualified opinion could be expressed because any such qualification could not avoid the possibility of misleading users of the statements. However, in this situation the auditor has advance knowledge of facts which could possibly result in such gross misstatement in the financial statements that it might be well to decline the engagement.

Commercial Law

May 20, 1955; 9 a.m. to 12:30 p.m.

Solution 1

Jones is entitled to compensation.

The general rule is that a contract, silent as to time, must be performed within a reasonable time. (Corbin, *Contracts*, Sec. 96 (1951); Williston, *Contracts*, Sec. 38 (rev. ed., 1937); *Crossland* v. *Kentucky Blue Grass Seed Growers' Assn.*, 103 F. 2d 565 (6th Cir. 1939).)

However, where acceptance of delayed performance by one party to a contract reasonably induces the belief in the other that time is not of the essence, this condition will be waived. (See, generally, Corbin, *Contracts*, Secs. 722, 754; Williston, *Contracts*, Sec. 856 (rev. ed., 1937).) Hitchcock's letter to Jones dated September 22 was followed by several conferences between the parties. Jones was given no indication during these conferences that the clinic was concerned about the delay in the completion of the audit. Hitchcock accepted Jones' preliminary figures. The facts of the case support a finding of waiver.

Where the time for performance has been waived by the contracting parties, neither can rescind on account of delay without notice to the other that unless performance is completed within a reasonable time the contract will be abrogated. (*Restatement, Contracts*, Sec. 311; Corbin, *Contracts*, Secs. 722, 754-5 (1951); Williston, *Contracts*, Sec. 856 (rev. ed., 1937); see *Guenther* v. *Gnagi*, 258 Wisc. 383, 46 N. W. 2d 194 (1951).)

Hitchcock, therefore, had no right to rescind the contract, and his letter of March 31, terminating Jones' engagement was, according to the majority view, an anticipatory breach of contract. This gave rise to a cause of action for damages on the part of Jones.

The question does not state whether there was an agreement as to the amount Jones was to receive as compensation. Accordingly, this answer assumes that there was no such agreement. Absent such an agreement, Jones would be entitled to the reasonable value of his services. (Williston, *Contracts*, Sec. 1459 (rev. ed., 1937).)

Solution 2

a. "An accommodation party is one who has signed the instrument as maker, drawer, acceptor, or indorser, without receiving value therefor, and for the purpose of lending his name to some other person." (*Uniform Negotiable Instruments Law*, Sec. 29.)

b. "Where a person, not otherwise a party to an instrument, places thereon his signature in blank before delivery he is liable as indorser in accordance with the following rules: (1) if the instrument is payable to the order of a third person, he is liable to the payee and to all subsequent parties; (2) if the instrument is payable to the order of the maker or drawer, or is payable to bearer, he is liable to all parties subsequent to the maker or drawer; (3) if he signs for the accommodation of the payee, he is liable to all parties subsequent to the payee." (*Uniform Negotiable Instruments Law,* Sec. 64.)

c. 1. "An indorsement is restrictive, which either (1) prohibits the further negotiation of the instrument; or (2) constitutes the indorsee the agent of the indorser; or (3) vests the title in the indorsee in trust for or to the use of some other person. But the mere absence of words implying power to negotiate does not make an indorsement restrictive." (*Uniform Negotiable Instruments Law,* Sec. 36.)

2. "A qualified indorsement constitutes the indorser a mere assignor of the title to the instrument. It may be made by adding to the indorser's signature the words 'without recourse,' or any words of similar import." (*Uniform Negotiable Instruments Law,* Sec. 38.)

3. "A conditional indorsement is one by which the indorser annexes some other condition to his liability." (1 Daniel, *Negotiable Instruments,* Sec. 697 (4th ed. 1891).)

d. 1. Two examples of restrictive indorsements are "for deposit only" and "for collection only." (See *Central National Bank* v. *Avenue State Bank,* 332 Ill. App. 543, 76 N. E. 2d 209 (1947); Brannen, *Negotiable Instruments,* Sec. 36 (5th ed. 1932).)

2. An example of a qualified indorsement is "without recourse."

3. An example of a conditional indorsement is found in *Keeler Bros.* v. *School District No. 25,* 276 Fed. 755, 756 (D. Ore. 1921): "Pay to Gilliam County, S.D., #25, in accordance with our bid for legal bonds, when approved by attorney and attached hereto."

e. 1. "Pay to C. Jones only." This language would render the instrument non-negotiable because "an instrument to be negotiable . . . must be payable to order or bearer." (*Uniform Negotiable Instruments Law,* Sec. 1(4); see Brannen, *Negotiable Instruments,* Secs. 1(4), 10 (5th ed., 1932).)

2. "Thirty days after my arrival in New York." This language would render the instrument non-negotiable because "an instrument to be negotiable . . . must be payable on demand, or at a fixed or determinable future time." (*Uniform Negotiable Instruments Law,* Sec. 1(3).) This instrument would be payable upon a contingency. The defect would not be cured by the happening of the event. (*Id.,* Sec. 4.)

Solution 3

a. No. B cannot recover damages from A for breach of an express warranty, because A's statements concerning the condition and value of the refrigerator were not express warranties. They were mere statements of opinion, or "puffing" of his wares. "No affirmation of the value of the goods, nor any statement purporting to be a statement of the seller's opinion only, shall be construed as a warranty." (*Uniform Sales Act,* Sec. 12.)

b. Yes. The statement that the motor had "just been overhauled" is a statement of fact which tends to induce the buyer to purchase the goods, and it amounts to an express warranty if the goods are purchased in reliance upon the statement. (*Uniform Sales Act,* Sec. 12.)

c. Probably not. It is the majority rule that a general warranty does not cover defects which are known to the buyer. Although the rule is primarily concerned with defects visible to the buyer, Williston states that it covers situations such as that here where the seller told the buyer of the defect. (1 Williston, *Sales,* Sec. 207 (rev. ed., 1948); see also 46 Am. Jur., *Sales,* Sec. 377.)

Solution 4

a. A voluntary sale of personal property by the person claiming to be the owner carries with it an implied warranty of title unless a contrary intention appears. (*Uniform Sales Act,* Sec. 13; see also 46 Am. Jur., *Sales,* Sec. 404.) An involuntary sale by a public officer (a "judicial sale"), on the other hand, transfers only what title the person had in the property. There is no warranty. (31 Am. Jur., *Judicial Sales,* Secs. 169, 170; annotation, 68 A.L.R. 659; 2 Bouvier's Law Dictionary, p. 2984 (8th ed., 1914).)

b. An f.o.b., or "free on board" sales contract is one that obligates the seller, at his own expense, to load the subject of the sale for shipment. The shipment is no longer free to the buyer once the goods are on board. (Black's Law Dictionary, p. 792 (4th ed., 1951).)

c. Bouvier's Law Dictionary, p. 483 (8th ed., 1914) defines a chose in action as "a right to receive or recover a debt, or money, or damages for breach of contract, or for a tort connected with contract, but which cannot be enforced without action."

d. Contracts, promissory notes, checks, trade acceptances, bonds and bank accounts are some of the forms of choses in action.

Solution 5

a. Hazard can recover a total of $20,000. Of this total $12,000 would be paid by the Asbestos Company and $8,000 by the Salamander Company. Under the 80 per cent co-insurance clause he should have insured for 80 per cent of value, or $80,000, and to the extent that he did not he was a co-insurer and must share the loss. Having insured for only $40,000 or half of the 80 per cent requirement, he can recover only half the loss, or $20,000. The formula is: Insurance divided by 80 per cent of value multiplied by loss. Under the pro-rata clause he would recover three-fifths of this, or $12,000, from the Asbestos Company and two-fifths, or $8,000 from the Salamander Company, in accordance with the proportionate amount of insurance written on the building by each company. (Vance, *Insurance,* pp. 878, 887-88 (3d ed. 1951); 29 Am. Jur., *Insurance,* Secs. 1181, 1326; see *Friel* v. *National Liberty Insurance Co.,* 71 F. Supp. 761 (E. D. Pa. 1947); *Templeton* v. *Insurance Co. of North America,* 356 Mo. 596, 201 S. W. 2d 784 (1947).)

b. A "floating" fire insurance policy covers property of a transitory nature, and not necessarily the identical property. It may supplement specific insurance on property and attaches only when the latter ceases to cover the risk. One purpose of such a policy "is to provide indemnity for property which cannot, because of its frequent change in location and quantity, be covered by specific insurance." (Black's Law Dictionary, p. 768 (4th ed. 1951); see 29 Am. Jur., *Insurance,* Sec. 733; *Davis Yarn Co.* v. *Brooklyn Yarn & Dye Co.,* 293 N.Y. 236, 56 N. E. 2d 564 (1944).)

c. An "insurable interest" exists when the insured derives pecuniary benefit or advantage by the preservation or continued existence of the property or will sustain pecuniary loss from its destruction. (4 Appleman, *Insurance,* Sec. 2123 (1942).)

d. The "standard" clause creates a collateral independent contract between the insurer and the mortgagee and provides that the rights of the mortgagee shall not be defeated by the acts or defaults of the mortgagor. A general rule results to the effect that the mortgagee's rights remain unaffected by any default or breach by the mortgagor to which the mortgagee is not a party.

Under the "open mortgage" clause, which merely designates the mortgagee as payee to the extent of his interest, the mortgagee is made merely a beneficiary under the contract and recognized as such by the insurer, but is not made a party to the contract itself. Any default by the mortgagor, which under the policy defeats his rights, also defeats all rights of the mortgagee under that contract even though the latter may not have been in any fault. (Vance, *Insurance,* pp. 775-76 (3d ed. 1951); *Conard* v. *Moreland,* 230 Ia. 520, 298 N. W. 628 (1941); *Goldstein* v. *National Liberty Insurance Co. of America,* 256 N.Y. 26, 175 N.E. 359 (1931).)

Solution 6

a. A novation may be defined as "the substitution of a new obligation for an old one, which is thereby extinguished." (2 Bouvier's Law Dictionary, p. 2375 (8th ed., 1914).)

"Novation" formerly applied only to the substitution of the obligation of one party for the obligation of another. Modern usage has broadened it to include any new contract entered into for the purpose and with the effect of dissolving an existing contract and creating a new one, whether or not there is a change of parties. (39 Am. Jur., *Novation,* Sec. 2.) But *Restatement, Contracts,* Sec. 424(c) still imposes the requirement that a new party be included in the new contract.

The element of novation to be looked for is the extinguishment of the old obligation; if this is not present, the arrangement is not a novation. (See *Martin* v. *Breckenridge,* 14 F.2d 260 (4th Cir. 1926); 39 Am. Jur., *supra,* Sec. 11; Corbin, *Contracts,* Secs. 1297, 1300 (1951).)

b. The phrase "accord and satisfaction" is applied to an agreement between two parties to give and accept something in satisfaction of a right of action which one has against the other. This agreement (the accord), when performed (the satisfaction), is a bar to all actions upon the former right. (1 Bouvier's Law Dictionary, p. 103 (8th ed., 1914); see, generally, 1 Am. Jur., *Accord and Satisfaction,* Secs. 1-3.)

c. An account stated is an agreement as to the correctness of items of an account, growing out of transactions between the parties. (1 Am. Jur., *Accounts and Accounting,* Sec. 16.) These transactions must be of the type that give rise to the relation of debtor and creditor, and cannot be unliquidated damage claims. (*Restatement, Contracts,* Sec. 422, com. a.) These items may all be owed by one party to the other; under modern views, there is no need for mutual debts and credits. (1 Am. Jur., *supra,* Sec. 19.)

An account stated is an agreement, and can be sued upon. (1 Am. Jur., *supra,* Sec. 16; *Restatement, Contracts,* Sec. 422(1); Corbin, *Contracts,* Sec. 1309 (1951).)

The sum arrived at in an account stated is supposed to be fixed primarily by way of computation, rather than by compromise. (*Restatement, Contracts,* Sec. 422, Com. b.)

d. Laches, generally, is "the neglect to do what should have been done for an unreasonable and unexplained length of time under circumstances permitting diligence; mere lapse of time before bringing suit will not constitute laches. Not only must there have been some unnecessary delay, but it must appear that, by reason of the delay, some change has occurred in the condition or relations of the property which would make it inequitable to enforce the claim." (Bouvier's Law Dictionary, p. 1821 (8th ed., 1914).)

e. A statute declaring that no suit shall be maintained on a specified type of cause of action unless brought within a specified period of time after the accrual of the right. (See Black's Law Dictionary, p. 1077 (4th ed., 1951).)

f. "Eminent domain" is the term used to refer to the right of the sovereign to take private property for public use. Under the federal constitution and most state constitutions, just compensation must be given to the owner. (18 Am. Jur., *Eminent Domain,* Secs. 2-4.)

g. Usury is the taking, or contracting to take, a greater sum for the use of money than the law permits. (See Black's Law Dictionary, p. 1714 (4th ed., 1951).)

Solution 7

a. 1. A title search is a careful examination of the public records to establish the record owner of real estate and to determine whether there are in existence of record, any mortgages, mechanics' or tax liens, judgments or other incumbrances or restrictions affecting the status of such land. (See Black's Law Dictionary, p. 664 (4th ed., 1951).)

2. An abstract of title is a condensed history of title to real property. It is taken for the information of a purchaser from the public records as to the parcel involved and covers prior conveyances and transfers showing chain of title to the owner, mortgages, mechanics' liens, judgments, taxes, and other liens and incumbrances bearing on the state of the vendor's title. (Black's Law Dictionary, p. 24 (4th ed., 1951).)

3. Title insurance may be defined as "a contract to indemnify the owner or mortgagee of real estate from loss by reason of defective titles, liens or incumbrances." (2 Bouvier's Law Dictionary, p. 1631 (8th ed., 1914).)

b. As a general rule, every landowner is entitled, under the doctrine of lateral support, to have his soil remain in its natural position without being caused to fall away by reason of excavations or other improvements made on the neighboring land. If there is a real danger that Whitehouse's field may collapse if the excavations continue, Whitehouse might be able to obtain a court order enjoining Forester from further excavating until provision was made to prevent a collapse. (1 Am. Jur., *Adjoining Landowners,* Secs. 21, 25, 45.) However, Forester will not be liable in damages to Whitehouse until there is an actual subsidence of his land. Once cave-ins have occurred, Whitehouse has a right to recover damages. (3 Tiffany, *The Law of Real Property,* Sec. 752 (3d ed., 1939).)

c. No. Carter has an easement by necessity. The rule has been stated as follows: "Such an easement ordinarily arises when one conveys to another land entirely surrounded by his, the grantor's, land. . . . Unless the conveyance is regarded as giving, as appurtenant to the land conveyed, a right of way over the land retained by the grantor, the grantee can make but limited use, if any, of the land conveyed to him." (3 Tiffany, *The Law of Real Property,* Sec. 793 (3d ed., 1939).)

Public policy favors the full utilization of land. The courts have therefore rationalized the "way of necessity" as an easement by implication. Absent evidence of a contrary intention, courts will infer that the parties intended to create such an easement. (*Restatement, Property,* Secs. 474, Com. a, 476, Com. a; 17 Am. Jur., *Easements,* Sec. 48.)

Solution 8

a. A majority of states have adopted the Uniform Partnership Act, which provides that the incoming partner "is liable for all the obligations of the partnership arising before his admission as though he had been a partner when such obligations were incurred, except that this liability shall be satisfied only out of partnership property." (*Uniform Partnership Act,* Sec. 17; see also Sec. 41.)

b. A dissolution is "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of the business." (*Uniform Partnership Act,* Sec. 29.) "On dissolution the partnership is not terminated, but continues until the winding up of partnership affairs is completed." (*Uniform Partnership Act,* Sec. 30; see *Hurley* v. *Hurley,* 91 A.2d 674 (Del. Ch. 1952).)

c. The estate of a deceased partner is liable for all obligations of the partnership incurred while the deceased was a partner, but subject to prior payment of the deceased's separate debts. (*Uniform Partnership Act,* Sec. 36 (4).)

d. Yes. Dissolution is caused by the bankruptcy of any partner. (*Uniform Parnership Act,* Sec. 31 (5).)

e. When A and B continued their business beyond March 1, 1955 they were operating as a "partnership at will." The provisions of the former agreement relating to their respective rights and duties will continue in effect, so far as consistent with a partnership at will. (*Uniform Partnership Act,* Sec. 23; *Corr* v. *Hoffman,* 256 N. Y. 254, 176 N. E. 383, 391 (1931).)

Solution 9

a. 1. A general agency is one in which the authority "extends to all acts connected with a particular business or employment." (2 Bouvier's Law Dictionary, p. 2690 (8th ed., 1914).) A special agency is one in which the authority is limited to the conduct of one or more specific transactions. (*Restatement, Agency,* Sec. 3.)

2. An express agency is one created either "by deed, in writing not by deed, or by a verbal delegation of authority." An implied agency is one "inferred from the relation of the parties and the nature of the employment, without proof of any express appointment." (2 Bouvier's Law Dictionary, pp. 2689-90 (8th ed., 1914).)

3. An actual agency is found where one person has manifested his consent to another "that the other shall act on his behalf and subject to his control." (*Restatement, Agency,* Sec. 1.) An ostensible agency is one "where the principal intentionally or by want of ordinary care causes a third person to believe another to be his agent who is not really employed by him." (Black's Law Dictionary, p. 85 (4th ed., 1951); see also *Restatement, Agency,* Sec. 8.)

b. Probably, yes. "One who in the course of his business or profession supplies information for the guidance of others in their business transactions is subject to liability for harm caused to them by their reliance upon the information if (a) he fails to exercise that care and competence in obtaining and communicating the information which its recipient is justified in expecting, and (b) the harm is suffered (1) by the person . . . for whose guidance the information was supplied, and (2) because of his justifiable reliance upon it in a transaction in which it was intended to influence his conduct or in a transaction substantially identical therewith." (*Restatement, Torts,* Sec. 552.)

If the matter is one which requires investigation, the supplier of the information must exercise reasonable care and competence to ascertain the facts on which his statement is based. (*Restatement, Torts,* Sec. 552 and Comment (c) on clause (a) thereof.)

Solution 10

a. The Fair Labor Standards Act provides that, subject to certain exceptions, persons working in interstate commerce or in industry producing goods for interstate commerce must be paid a minimum wage (at the time of the examination, 75¢ an hour); and that they cannot be employed more than 40 hours a week unless they are paid time-and-a-half for overtime. It also prohibits the employment of children under the age of 14 years. It permits the employment of children between the ages of 14 and 16 years in all industries, except mining and manufacturing, under certain prescribed conditions. (29 U.S.C., Secs. 201-219.)

b. The Social Security Act establishes a federal system of old-age assistance and aids the states in making more adequate provision for the aged, the blind, dependent and crippled children, and for maternal and child welfare, public health, vocational rehabilitation, and unemployment compensation. (See, generally, Title 42 of U.S. Code, particularly Secs. 31 *et seq.*, 200 *et seq.;* Secs. 1331-33, 1351-52.)

c. The essence of the Robinson-Patman Act is the provision that it shall be unlawful for any person engaged in interstate commerce "in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality . . . where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination or with customers of either of them." (15 U.S.C., Sec. 13.)

d. Section 1(b) of the Labor-Management Relations Act, 29 U.S.C., Sec. 141(b) states as follows:

"It is the purpose and policy of this Act, in order to promote the full flow of commerce, to prescribe the legitimate rights of both employees and employers in their relations affecting commerce, to provide orderly and peaceful procedures for preventing the interference by either with the legitimate rights of the other, to protect the rights of individual employees in their relations with labor organizations whose activities affect commerce, to define and prescribe practices on the part of labor and management which affect commerce and are inimical to the general welfare, and to protect the rights of the public in connection with labor disputes affecting commerce."

The Act specifies the powers and organization of the National Labor Relations Board and its General Counsel's Office, defines unfair labor practices of employers and labor organizations and their agents, and provides for ascertaining bargaining units, supervision of elections among employees and designation of collective bargaining representatives. The Act also empowers the Board to conduct hearings, issue orders and obtain court injunctions in certain circumstances. Rights of employees to join a labor organization, present grievances to employers and strike are affirmed. (29 U.S.C., Sec. 141 *et seq.*)

e. The Securities Act of 1933 requires that, with certain exceptions, securities must be registered with a commission of the federal government before they may be sold or offered for sale in interstate commerce. It also provides that information relating to such securities must be disclosed. Civil and criminal sanctions are imposed to enforce the Act. (The Federal Trade Commission was originally given the duty to administer the Act.) (15 U.S.C., Sec. 77.)

f. The Securities Exchange Act of 1934 provides for the registration of securities exchanges (with the exception of relatively small exchanges). Brokers, dealers and other exchanges are forbidden to deal with an exchange that has not complied with the Act.

Registration of an exchange is allowed only if certain criteria are met; these criteria forbid operations and practices which are deemed detrimental to the public interest. In particular, margin trading is regulated and practices which artificially affect prices are discouraged. Registration of securities is also required. The Act created the Securities and Exchange Commission to administer its provisions, and provided civil and criminal sanctions. (The Securities and Exchange Commission was also given responsibility for the administration of the Securities Act of 1933.) (15 U.S.C., Sec. 78.)

Theory of Accounts

May 20, 1955; 1:30 to 5 p.m.

Solution 1

Consistency, as used by accountants, means that over a period of time the same methods or treatment of accounting matters are being followed. What is done this period is in conformity with what was done in previous periods. In this sense, the use of the lower of cost or market method of inventory valuation, followed year after year, is consistent. However, while during a period of rising prices inventories probably will be stated at cost, which generally will be less than market, in a period of declining prices the opposite will normally be true—market will be lower than cost. Over a period of time in which there is fluctuation of prices both upwards and downwards, in some years the method yields inventory stated at cost but in other years it will be stated at market. For this reason some accountants consider this method as being inconsistent rather than consistent, because of the "internal inconsistency" of the method itself even when applied "consistently."

The term "conservative" means that of two alternatives, each having some reasonable support, one should choose the least favorable alternative from the standpoint of net equity. In the case of assets, the lower of the two alternative valuations should be chosen. Liabilities should be stated at the higher of the two alternatives. It is assumed that it is conservative to postpone showing revenue until a later period if some basis for such postponement exists. Expenses, on the other hand, should be reflected at the earliest possible moment.

Assuming that market is lower than cost at the end of any given period, this inventory valuation method will be conservative both as it applies to the balance sheet (asset stated at the lower of two alternatives), and as it applies to the income statement (net income being stated at a lower amount than if cost had been used as the inventory valuation basis). However, in the succeeding accounting period, the net income will be increased by exactly the same amount that it was decreased in the prior period. This second year's income statement can be said to be "non-conservative"—rather than conservative.

In summary, it may be said that the inventory, as stated in the balance sheets, will be conservative over a period of time, in that it will always be stated at the lower of two possible alternatives. However, the income statement may yield a "conservative" income figure in any one period, but it will always be "non-conservative" in some succeeding period. While application of the "cost or market" rule is generally accepted as consistency in accounting method, its results may produce inconsistent income figures.

Solution 2

a. 1. The fact that there are fully-depreciated assets which are still in use might have been caused by several factors. Investigation may reveal that the depreciation rate was originally set too high. Also circumstances may have changed since the rate was set, or conditions may not have developed as expected. For instance, most depreciation rates include an element for normal obsolescence, but this may not have occurred. Also it is possible that various expenditures have been charged directly to operations when they should have been capitalized. Maintenance may have been more complete than was originally anticipated. Also, since depreciation is at best an estimate based on averages of past experience, it is rather common to find some assets becoming useless before they are fully depreciated while others become fully depreciated before losing all usefulness.

2. There are a number of factors involved in a decision by management to abandon or replace fixed assets and the remaining book value of the assets is not usually one of those factors. The current and expected rate of operations, the financial position of the company, the rate of improvement in types of equipment are examples of such factors. Most fixed assets could be continued in use beyond their normal economic life. The fact that fully-depreciated assets are in use may not indicate that under other circumstances they would be continued in use. Maintenance may be high and productivity low; but for financial or other reasons, management may not immediately make replacements.

However, if the assets are making a substantial net contribution to income, the existence of these assets indicates that current income is being overstated to the extent that there is no charge for depreciation. Conversely, net income of past periods has been understated through excessive depreciation charges.

b. A decision as to the propriety of carrying fully-depreciated, but still productive, assets as indicated in the question depends primarily upon the materiality of the amounts involved. If the amounts are not material, such treatment may be accepted, but solely because of lack of materiality; and in such circumstances, some accountants write off the fully-depreciated assets against their related depreciation accounts. If the amount is material as to its effect on income, there is reason for making an adjustment of prior years' recorded profits or losses and consequent adjustment of the fixed assets and accumulated depreciation accounts to provide a new basis for present and future depreciation charges. If the amount is material but the restatement suggested above is not considered to be necessary, the following two balance-sheet presentations would be more acceptable than that adopted by the client in the past:

1. Amounts of these assets and related depreciation included among those for other fixed assets, but with a footnote (or parenthetical note) disclosing the amount of the fully-depreciated assets.

2. Amounts of these assets and related depreciation segregated from other fixed amounts and separately identified on the balance sheet.

Solution 3

a. The fact that the change took place should be disclosed together with the effect of the change. The change destroys the comparability of balance sheets at December 31, 1953 and December 31, 1954. It also affects income for 1954. Without disclosure, the users of the statements could be misled.

The disclosure is customarily made in a footnote. The footnote could state what the inventory or profits would have been if the change in method had not been made. A more informative disclosure, however, might be to show what the profits would have been if the beginning inventory had been stated on the new basis.

b. The additional assessment would be shown as a separate item on the income statement, if material. If immaterial it would be included with the current year's expense. Adjustment through retained earnings would normally be unacceptable unless inclusion of the item in the income statement would tend to mislead users of the statement. Showing the item separately on the statement gives adequate disclosure of it.

c. If the error at December 31, 1953 was immaterial, no adjustment would be made. If the error was material, the income statement should show the correct expense for 1954 and as a separate item show the effect of the error at December 31, 1953. A statement title such as "Adjustment of prior year's profit" would be appropriate. Adjustment through retained earnings would normally be unacceptable. A separate showing of the item provides adequate disclosure.

d. The new estimate would be used in calculating depreciation expense for 1954. No adjustment of the reserve at the beginning of the year would be made. Instead, the remaining unamortized cost would be divided by the estimated remaining life. This is not a change in method and is not to be considered as a breach of consistency. It does not require special disclosure in the statements. By nature, depreciation is an estimate and it is contemplated that revisions of the estimate may be made as better information becomes available. While only 10 years of the original estimated life remain, the new rate based on cost would be 1.43 per cent compared with a corrected rate from the beginning of 2.22 per cent.

Solution 4

a. In general there are two points at which significant analyses may be made, namely: (1) at the point of acquisition of materials, labor and other services, and (2) at the point of emergence of the finished product. In specific cases other points may be present while work is in process, but this will depend upon the special characteristics of the operations conducted by each company under review.

b. At the point of acquisition, quantities acquired and unit prices paid are available, and can be analyzed, including in the analysis a calculation of the quantities of finished output which should emerge. In lieu of the point of acquisition, the point at which work is put into process (labor, materials, overhead) may be conveniently used. If the point of emergence of finished product is used, then calculations may be made starting with the actual product obtained, and working back to the quantities which ought to have gone into their production. By comparison with the actual quantities used, a measure of waste and inefficiencies may be obtained. In terms of effective timely control, the earlier points are preferable to the later points, but in terms of accuracy and definiteness the later points have the advantage. A combination of the two approaches is frequently used to good advantage.

The accounting techniques available may be summarized as budgetary control and standard cost systems. Numerous types of each are in actual use, varying from a limited use of budgets and standards to an attempt completely to control (on the record level) all phases of operations. The essential underlying feature of each of these methods, however, is the same, namely, the derivation "automatically" from the record of the variations between some bench mark or standard and the actual observed performance. The critical problem then is to analyze the variations (variances) and explain them in causal terms.

Solution 5

This is a problem involving fixed and common costs. Within considerable limits, the cost of operating a bank would not change because of the addition of new accounts or the loss of old ones. The depreciation and other costs associated with the bank building, fixtures and equipment, the salaries of officers, and other such items are fixed costs of operations within very wide limits. There would have to be a considerable change in the number of accounts before even the staff of tellers or bookkeepers would be increased or decreased.

There is much joint use of facilities among the various phases of bank operations. For example, the vault houses not only the files of commercial accounts, but also the savings account records, collateral on loans, coins and bills, and many other types of property and records. Unless the bank is large and the work highly specialized, a teller will handle a good many types of operations during a working day. A given official may make loans, open new accounts, advise customers as to investments, and so on. It would be extremely difficult to assign many of such operating expenses to any particular type of operation, let alone any account.

The problem of determining a reasonable and useful cost for handling an account involves obtaining data as to costs of functions and number of transactions handled so that the direct or semidirect costs may be determined. The average labor cost per transaction for tellers and for transit, clearings and bookkeeping functions can be obtained with considerable accuracy. Then it becomes necessary to allocate costs of all other necessary functions to these and other principal banking operations. Like all allocations of fixed or indirect overhead, the allocations will be arbitrary, but they can be made in a reasonable and logical manner by using appropriate bases.

While the costs obtained from such an accounting procedure may be useful for setting service charges, it must be recognized that they do have one important limitation. They are average costs and not "differential costs." Therefore they have limited usefulness for certain types of management decisions relating to expansion or contraction of services or changes in operations.

Solution 6

a. There is no one figure of surplus in a government. The resources and obligations, assets and liabilities of a government must be analyzed and classified by funds. Each fund is a distinct financial or fiscal entity and has its own surplus or deficit. The surplus of a government, therefore, consists of the surplus or deficit of each of its various funds.

It is also essential that a clear segregation be made between the accounts relating to current assets, liabilities and operations, and those relating to fixed assets and liabilities. Asset accounts for permanent property are not available to meet expenditures or obligations and therefore should be segregated from other fund assets. The equity represented by permanent property should not be included in the current surplus of any fund but should be shown as a separate item.

b. The surplus of a current fund may be made up of the following items: (1) That amount reserved to provide for working capital or other specific items. (2) That amount reserved to cover encumbrances in the form of unfilled purchase orders and uncompleted contracts. (3) That amount represented by unencumbered balances in appropriations, against which expenditures and commitments may still be made. (4) Balance of unappropriated surplus available for any purpose to which the legislative body may legally apply it.

The aggregate of these items constitutes the current surplus of the fund which represents the excess of assets of the fund over liabilities. During the course of a fiscal period one of the resources of a fund will be unrealized revenues. Obligations of the fund will also include encumbrances for unfilled orders and contracts and unencumbered balances in appropriations. During the course of a fiscal period, therefore, the balance of unappropriated surplus is in part an estimated figure. At the close of the period budgetary accounts for estimated revenues and for appropriations ordinarily are closed to surplus so that the balance becomes a real surplus.

During the course of the fiscal period a surplus account may be kept for unappropriated budget surplus representing the excess of estimated revenues over appropriations for the period. This account would be closed at the end of the fiscal period.

The balance of the surplus account at any time indicates the amount available for appropriation.

Solution 7

a. Straight-Line Method:

Arguments for the method include the following:

1. The straight-line method is an easy method to calculate and to apply.
2. Obsolescence and the wear and tear of the elements, important causes of depreciation, are both factors of "time" and occur whether or not the machine is in use.
3. The original cost of a fixed asset is merely a prepaid expense and should be allocated between periods in the same fashion as are most prepaid expenses.

Arguments against the method include:

1. Obsolescence and the wear and tear of the elements should be considered in the original estimate of the life of the machine. Once this "economic life" is logically established, then other factors such as the amount of use and the extent of the machine maintenance are more important considerations.
2. This method causes a varying rate of per-unit depreciation charges against identical units if there are any variances in production schedules.
3. Even if the original cost of an asset is considered a prepaid expense, it should be allocated between periods in a logical and rational manner, as should any prepaid expense. If the straight-line method is not indicative of the service rendered by the asset during each period, then some other depreciation method should be used.
4. The income produced from the use of an asset is likely to be greatest during the early years of service and the cost of operations is likely to be lowest in the same period indicating that the method may not match costs with revenues as closely as would be desirable.
5. The method leaves a higher value on the books than some other methods during early years of estimated life. Because of uncertainty as to obsolescence or supersession, this may be objectionable.

b. Unit-of-Production Method:

Arguments for the method include the following:

1. A machine is purchased to fulfill a certain task, i.e., to produce (or assist in the production of) certain units. In this sense, a machine is a "store" of production and should be expensed as this "store" is being used up.
2. The primary cause of depreciation is the use of the machine at its task. Therefore, the amount of use, measured in terms of units of production, is the best measure of a periodic depreciation expense.
3. The use of this method of depreciation will yield a uniform cost-per-unit charge against all similar units produced. This will reduce the work load in cost accounting, and units produced during a slow period will not be burdened with a higher depreciation rate than identical units produced during a rush period.

Arguments against the method include:

1. It is very difficult, if not impossible, to estimate soundly the total number of units that an assembly line machine is capable of producing. It is even more diffi-

cult to estimate the future demand for the product, and therefore the machine's economic life.

2. A machine undergoes some "depreciation" even when it is not being used. Therefore, some expense for depreciation should be recognized even during periods of non-use. No original estimate can foresee all possible delays.

3. Every significant change in the use of the machine or in the units being produced would mean there would have to be a new estimate of total remaining production "stored up" in the machine.

c. Sum-of-the-Years'-Digits Method:

Arguments for the method include the following:

1. By the use of an accelerated method of depreciation such as the sum-of-the-years'-digits method, the depreciation charge plus the maintenance charge applicable to a fixed asset may amount to an almost equal charge against the machine, during each year of its life. This is true because an accelerated method of depreciation causes heavy charges in earlier years that are substantially reduced in later years, while maintenance charges are nominal in early years and substantially increased in later years. Maintenance charges are actually "depreciation" charges in that they prevent or "make good" loss of usefulness and should be added to depreciation charges based on costs to arrive at a true measure of depreciation.

2. A machine is more productive in its earlier years and normally is used more, therefore most depreciation occurs in the earlier years, both in terms of wear and tear and in returns of volume of production.

3. Heavier charges against income in earlier years are some insurance against dispersion of assets through dividend payments in those cases involving an overestimate of the life of the asset.

Arguments against the method are:

1. Depreciation charges are a means of spreading the "cost" of a fixed asset over its useful life. It is not a means of "smoothing" periodic income. Maintenance charges are an item of current expense separate and apart from the depreciation expense. If maintenance charges are significantly higher in the later years of a machine, it may be a sign that the machine has become inefficient, and this fact should not be buried by an "averaging" technique.

2. It is not the job of the depreciation method to provide for a retention of assets. Though it is true that an accelerated depreciation method can aid in the rapid "recovery" of cost, it should not be used if it also results in an overstatement of depreciation expense in the earlier years.

3. There is adequate data to support the contention that fixed assets generally require more maintenance in later years, but there is not adequate data to prove that depreciation based on the sum-of-the-years'-digits method accurately measures this gradual increase in maintenance charges.

Solution 8

a. 1. All current assets, including cash, unless covered by forward exchange contracts should be valued in dollars at the rate of exchange prevailing on the balance-sheet date. In the present case the official rate of exchange would generally be the rate for valuation purposes, for these reasons: (1) it is more conservative, and (2) the official rate is the rate at which purchases of foreign exchange are made and payments on open account are made.

2. Fixed assets should be valued in dollars at the rates prevailing when such assets were acquired or constructed. If the assets were paid for in dollars, that amount of course should be used. A very limited exception to the foregoing is permitted where assets were acquired shortly before a substantial and presumably permanent change in the exchange rate. Depreciation should be computed upon the dollar valuation of the assets.

3. The valuation of inventory should be at the lower of cost or market. In theory a strict cost basis requires a valuation of each unit at the time of acquisition. However, Accounting Research Bulletin 43, Ch. 12 (par. 15) provides that the burden of proof is on those who wish to follow some other procedure than the valuation of inventory at the rate of exchange existing on the balance-sheet date. A procedure sometimes followed is to use the lowest of the effective rates at the date of purchase, the average monthly rate over the period of acquisition or manufacture, or the quoted rate at the balance-sheet date.

   Where the selling price of an article obtainable in dollars, after deducting a reasonable estimate for selling and other expenses, is greater than the cost in dollars at the rate prevailing on the date of purchase, such original dollar equivalent may be considered as cost for inventory purposes.

4. Current liabilities should be valued in dollars at the rate of exchange prevailing at the balance-sheet date.

5. Long-term debts are valued in dollars at the rate of exchange when the liability was originally incurred or issued.

b. The gain or loss upon conversion of the assets of the foreign branch from foreign currency into dollars is an unrealized gain or loss. Ordinarily unrealized losses should be charged against operations.

Unrealized gains should preferably be carried to a suspense account. An exception is made if the credit arises from a recovery of the exchange rate from a previously written-down level, and such profit may properly be credited to income.

c. June 30, 1954

Notes receivable	$100,000	
Sales		$100,000
Cost of goods sold	$ 75,000	
Finished goods inventory		$ 75,000
To record sale of merchandise		

December 31, 1954

Loss on foreign exchange	$ 25,000	
Reserve for loss on foreign exchange		$ 25,000
To record loss due to change in rate of exchange		

March 15, 1955

Cash	$125,000	
Reserve for loss on foreign exchange	$ 25,000	
Notes receivable		$100,000
Income from foreign exchange		$ 50,000
To record payment of note		

Note: The decline in foreign exchange must be recognized at December 31, 1954. Since the note is a current asset, it is equally acceptable to credit notes receivable $25,000 in lieu of setting up the reserve for loss on foreign exchange. By not covering the note when received by a future sale of foreign exchange, any gain or loss from the fluctuation in rates of exchange must be considered as a separate transaction from the original sale of the merchandise. Therefore, it would be improper to debit sales at December 31, 1954 to reflect the loss on the foreign exchange.

Solution 9

a. A Statement of Affairs would be prepared. The most common sections of such a statement are as follows:

Fully-Pledged Assets
Partially-Pledged Assets
Free Assets
Preferred Creditors
Fully-Secured Creditors
Partially-Secured Creditors
Unsecured Creditors
Capital

The usual column headings for a Statement of Affairs include:

Book Value of Assets
Appraised Value of Assets
Estimated Shrinkage

Amount Available for General Creditors
Book Value of Liabilities
Unsecured Claims

A Statement of Estimated Deficiency is also prepared. Sections included in this statement are as follows:

Estimated Shrinkage in Value of Assets
Estimated Gain in Value of Assets
Estimated Cost of Liquidation
Capital

b. To prepare a Statement of Affairs and a Statement of Estimated Deficiency the following data should be obtained:

1. Trial balance at the end of the most recent month.
2. All the necessary adjustments for accrued and deferred items, especially the unpaid salaries and wages which would be preferred claims.
3. The secured liabilities and pledged assets, if any.
4. The expected proceeds to be obtained upon the forced liquidation of each asset.
5. The estimated cost of administration of a bankruptcy proceeding.

Answers to Examinations, November, 1955

Accounting Practice—Part I

November 2, 1955; 1:30 to 6 p.m.

Solution 1

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

Solution 2

SMITH COMPANY
Reconstruction of Transactions

Cash			
(1)	302,000	325,000	(4)
(3)	12,000	45,000	(5)
(17)	150,000		

Prepaid Insurance			
(13)	1,900	1,500	(12)

Notes Receivable			
(2)	20,000	12,000	(3)

Plant and Equipment			
(5)	95,000		

Accounts Receivable			
(2)	340,000	302,000	(1)

Mortgage Payable			
		50,000	(5)

Raw Materials			
(7)	125,000	118,000	(6)

Accrued Mortgage Int.			
		750	(14)

Finished Goods			
(9)	280,000	250,000	(8)

Accrued Wages			
(15)	145,100	147,000	(16)

Supplies			
(10)	18,000	14,000	(11)

Capital Stock			
		150,000	(17)

Work in Process			
(6)	118,000	112,000	(9)
(11)	14,000	112,000	(9)
(12)	1,000	56,000	(9)
(16)	116,500		
(16)	44,500		

Vouchers Payable			
(4)	325,000	125,000	(7)
		18,000	(10)
		1,900	(13)
		145,100	(15)
		75,500	(16)

Sales

	360,000 (2)

Cost of Goods Sold

(8) 250,000	

Selling Expense

(16) 27,500	

Administrative Expense

(12) 500	
(16) 28,500	

Financial Expense

(14) 750	
(16) 5,500	

Note: From the information given it is not possible to determine the portion of the individual expense accounts that consisted of wages and salaries, but the total can be determined.

Explanation of entries is as follows:

(1) To record the collection of Accounts receivable.
(2) To record Sales on account and for Notes receivable.
(3) To record the collection of Notes receivable.
(4) To record the payment of Vouchers.
(5) To record purchase of Plant for cash and for a mortgage payable.
(6) To record the issuance of Raw materials to Work-in-process.
(7) To record purchase of Raw materials on account.
(8) To record the cost of Finished goods sold.
(9) To record the transfer of Finished goods from process consisting of $112,000 Direct labor, $112,000 Material and $56,000 of Manufacturing overhead.
(10) To record purchase of Supplies on account.
(11) To record issue of Supplies to production.
(12) To record expiration of Insurance and allocation to Administration expense and to Manufacturing.
(13) To record purchase of Insurance on account.
(14) To record accrual of Interest on mortgage.
(15) To record set up of Vouchers for accrued wages.
(16) To record accrual of Wages and remaining Vouchers as shown by cost and expense accounts. (Of the total Wages, $116,500 can be identified as Direct labor, but the remaining amount cannot be identified.)

Solution 3

a. **ENGINEERING CONSTRUCTION COMPANY**

Balance Sheet, December 31, 1954

ASSETS

Cash			$2,309,050
Account receivable on contract (Sch. 1) (Note 1)		$4,250,000	
Inventories:			
Work in process	$185,625		
Material and supplies	230,250	415,875	
		$4,665,875	
Advance on construction contract (Note 2)		750,000	3,915,875
Plant facilities (cost—$3,175,000 less amortization of $2,032,000)			1,143,000
Total			$7,367,925

LIABILITIES

Current Liabilities:			
Accounts payable to trade creditors		$ 125,750	
Accrued payroll		27,200	
Income tax withheld from compensation of employees	$ 22,750		
Income taxes	1,500,000		
Social security taxes	20,325	1,543,075	
Total current liabilities			$1,696,025
Capital stock and retained earnings:			
Capital stock—authorized and outstanding—50,000 shares of $100 par value		$5,000,000	
Retained earnings		671,900	5,671,900
Total			$7,367,925

NOTE 1. This might be separated to show the billed and the unbilled amounts.

2. Since $250,000 of this will be applied against the $2,500,000 of unbilled receivables, the remaining $500,000 could be shown in the liability section.

b.

ENGINEERING CONSTRUCTION COMPANY

Statement of Income

For the Period from January 1, 1952 to December 31, 1954

Income—representing allowance for completed work based upon engineering estimates			$20,000,000
Cost of completed work:			
Construction costs—direct		$10,150,350	
Amortization of plant facilities (Sch. 3)	$2,592,000		
Maintenance and operation	2,045,750		
Administrative and general expenses	1,525,000	6,162,750	16,313,100
Net income from completed work			$ 3,686,900
Profit from sale of equipment (Sch. 4)			285,000
Net income before provision for income taxes			$ 3,971,900
Provision for federal and state taxes based upon income			2,300,000
Net income for the three years			$ 1,671,900

c.

ENGINEERING CONSTRUCTION COMPANY

Statement of Retained Earnings

For the Three Years Ended December 31, 1954

Net income	$ 1,671,900
Dividends paid	1,000,000
Retained earnings, December 31, 1954	$ 671,900

Supporting Computations

SCHEDULE 1

Account receivable on contract

Income—80% of $25,000,000	$20,000,000
Less amount received—$17,500,000 less 10% retained	15,750,000
Balance	$ 4,250,000

SCHEDULE 2

Plant facilities

Plant facilities (cost)	$ 4,050,000
Less facilities sold	875,000
Balance	$ 3,175,000

SCHEDULE 3

Amortization charged to cost of completed work

Plant facilities	$ 4,050,000
Less estimated salvage value	810,000
Remainder	$ 3,240,000
	80%
Amortization charge	$ 2,592,000
Amortization on asset sold	560,000
Applicable to present facilities	$ 2,032,000

SCHEDULE 4

Profit from sale of equipment

Sales price		$ 600,000
Cost of equipment	$875,000	
Less estimated salvage	175,000	
Remainder to be amortized	$700,000	
Amortization—80% of $700,000	560,000	
	$140,000	
Add estimated salvage value	175,000	315,000
Profit on sale		$ 285,000

Solution 4

a.

PIPE COMPANY

Cost Statement

	Total Cost	Total Quantity	18" Cost	18" Quantity	24" Cost	24" Quantity	30" Cost	30" Quantity
(1)								
Raw materials used—pounds		6,158,000		1,080,000		2,550,000		2,528,000
Raw materials used (Sch. 1)	$18,474		$3,240		$ 7,650		$ 7,584	
Cost per pound	.003							
Direct labor—days worked		241		60		102		79
Direct labor cost	13,255		3,300		5,610		4,345	
Cost per day	55							
Manufacturing overhead (Sch. 2)	10,604		2,640		4,488		3,476	
Cost per day (80% of labor)	44	241		60		102		79
Total cost of production	$42,333		$9,180		$17,748		$15,405	
Cost per foot			$1.275	7,200	$ 1.74	10,200	$2.4375	6,320
(2) Sales price per foot			2.200		3.00		4.0000	
Gross profit per foot			$ .925		$ 1.26		$1.5625	
Production per day				120		100		80
Gross profit per day			$ 111		$ 126		$ 125	
Ending inventory—feet				1,000		2,080		1,320
(3) Value of inventory	$ 8,111		$1,275		$ 3,619		$ 3,217	

SCHEDULE 1

Purchases	$17,657
Freight	2,447
Total	$20,104
Closing inventory	1,630
Material used	$18,474

SCHEDULE 2

Depreciation—building	$ 600
Depreciation—machinery	3,000
Electric power	1,519
Shop supplies	2,550
Repairs	2,175
Other factory expense	760
Total overhead	$10,604

b.

PIPE COMPANY

Estimated Cost of 36″ Pipe

	Cost per foot
Raw materials—500 lbs. @ $.003	$ 1.5000
Direct labor—$55 per day ÷ 64 ft.	.8594
Overhead (80% of labor)	.6875
Total cost	3.0469
Sales price	5.0000
Gross profit per foot	1.9531
Production per day	64
Gross profit per day	$125.0000

Solution 5

a.

SMITH MEDICAL FOUNDATION

Plant Fund—Journal Entries
December 31, 1954

(1)		
Due from General Fund	$100,000	
Contributions for Plant Acquisition		$100,000
To reflect cash donated for acquisition of plant as a receivable from the General Fund to the Plant Fund		
(2)		
Land	75,000	
Building	100,000	
Due to General Fund		175,000
To reflect the cost of plant property purchased as a payable from the Plant Fund to the General Fund		
(3)		
Building	39,000	
Due to General Fund		21,000
Surplus Invested in Plant		18,000
To reflect the excess of expenditures for repair and rehabilitation over the net income from plant operations as a payable from the Plant Fund to the General Fund		
(4)		
Land	6,000	
Surplus Invested in Plant		6,000
To reflect the cost of grading and seeding of yards as an addition to the cost of land rather than a charge to plant operation		
(5)		
Unexpired Insurance	1,000	
Due to General Fund		1,000
To charge the Plant Fund with the amount of unexpired insurance premiums purchased by the General Fund		

(6)

Due from General Fund	3,000	
Rent Collected in Advance		3,000
To credit the Plant Fund with rents collected in advance by the General Fund		

(7)

Surplus Invested in Plant	6,662	
Reserve for Depreciation of Building		6,662
To record depreciation on building for the year 1954, as follows:		

$100,000 at 5% for twelve months	$5,000
24,000 at 5% for eleven months	1,100
15,000 at 5% for nine months	562
Total	$6,662

(8)

Depreciation Fund	6,662	
Due to Depreciation Fund		6,662
To establish a Depreciation Fund by recording a liability equivalent to the provision for depreciation for the year 1954		

b.

SMITH MEDICAL FOUNDATION

Balance Sheet, December 31, 1954

ASSETS

General Fund	
Cash	$ 42,000
Investments	217,000
Due from Plant Fund (Note 1)	94,000
Total General Fund	$353,000
Plant Fund	
Depreciation fund—see contra (Note 2)	$ 6,662
Land and buildings—at cost	$220,000
Less reserve for depreciation	6,662
Property, net book value	$213,338
Unexpired insurance premiums	1,000
Total Plant Fund	$221,000
Total assets	$574,000

LIABILITIES

General Fund	
Accounts payable	$ 6,000
Surplus	347,000
Total General Fund	$353,000
Plant Fund	
Rents received in advance	3,000
Due to General Fund	94,000
Due to Depreciation Fund—see contra	6,662
Contributions for plant acquisition	100,000
Surplus invested in plant	17,338
Total Plant Fund	$221,000
Total liabilities	$574,000

NOTES: 1. This may be reconciled with the original $96,000 by deducting $3,000 rent and adding $1,000 unexpired insurance from the $96,000.

2. A separate fund may be created with a receivable as the asset until such time as cash is available.

Accounting Practice—Part II

November 3, 1955; 1:30 to 6 p.m.

Solution 1

a.

Total net worth of Store #3—12/31/53		$ 60,000
Add: Agreed value of fixtures and equipment	$ 18,000	
Less: Book value of fixtures and equipment	12,000	
Increase in asset values over book values		6,000
Adjusted net worth at January 1, 1954		$ 66,000
One-third interest therein		$ 22,000
Cash to be paid by Costello:		
To Abbott	$ 11,000	
To Barnes	11,000	
Total payment per above		$ 22,000

b.

A. B. C. GROCERY CO.

Statement of Profit and Loss—For the Year Ended December 31, 1954

Sales			$620,000
Cost of Goods Sold:			
Inventory—January 1, 1954	$ 63,000		
Merchandise purchases	493,000	$556,000	
Inventory—December 31, 1954		60,000	
Cost of Goods Sold			496,000
Gross Profit on Sales			$124,000
Operating Expenses:			
Salaries and wages (note)		68,000	
Depreciation		3,750	
General expenses		26,300*	
TOTAL OPERATING EXPENSES			98,050
NET INCOME FOR YEAR ENDED DECEMBER 31, 1954			$ 25,950

(*Adjusted for decrease of $900 in prepaid expenses)

Note: Manager's salary may be treated as an expense.

Distribution of Income:

Net Income per above	$25,950	
Less: Partner's salary	9,000	
Income to be divided	$16,950	
Mr. Abbott — 1/3 Income above		$ 5,650
Mr. Barnes — 1/3 Income above		5,650
Mr. Costello — 1/3 Income above	$ 5,650	
Salary	9,000	14,650
Total income per above		$25,950

c.

ABBOTT AND BARNES

Taxable Income—1954

			Abbott	*Barnes*
Partnerships:				
A & B Grocery Stores			$55,000	$55,000
A. B. C. Grocery Co.		$5,650		
Add: Share of depreciation taken on fixtures & equipment—Original contribution to partnership		1,200		
		6,850		
Less: Depreciation at old basis ($12,000 remaining life 5 years) 1/3		800		
Total taxable income from A.B.C. Grocery Co.			6,050	6,050
Interest income			4,000	3,000
Outside Interests:				
Long-term gain or (loss)			$4,000	(3,000)
Sale of partnership interest in A & B Store:				
Sale price	$11,000			
Basis — 1/3 of capital	10,000		1,000	1,000
Net gain or loss			$5,000	$(2,000)
Reported (Abbott 50% and Barnes subject to limitation)			$ 2,500	$(1,000)
Total taxable income			$67,550	$63,050

Solution 2

X. Y. Z. PARTNERSHIP

Possible Losses on Dissolution

		X		Y	Z	
	Total	Capital and Current Accounts	Loan Account	Capital and Current Accounts	Capital and Current Accounts	Loan Account
Balances before realization	$75,500	$21,500	$15,000	$23,000	$11,000	$5,000
Possible loss to eliminate Z	55,000	22,000		22,000	11,000	
Balances	20,500	(500)	15,000	1,000		5,000
X's loan applied against his capital deficit		500	(500)			
Balances	20,500		14,500	1,000		5,000
Possible loss to eliminate Y, applied against X's and Z's loans	2,500		1,000	1,000		500
Balances	18,000		13,500			4,500
Possible loss to eliminate Z's loan	13,500		9,000			4,500
Balance	$ 4,500		$ 4,500			

Schedule of Cash Payments on Realization of Assets

	X	Y	Z
First $4,500	$4,500	—	—
Next $13,500	9,000 (2/3)	—	$4,500 (1/3)
Excess over $18,000	.4	.4	.2

Alternate Solution

Since losses must be absorbed in the profit-and-loss ratio and loans can be applied against possible capital deficiencies, a short computation can be made as shown in the schedule below.

By working back up this schedule it is seen that the first $4,500 should be paid on the loan from X, the next cash up to $13,500 to X and Z in the ratio of 2 to 1 on their loans and all amounts thereafter would be distributed on the profit-and-loss ratios, with loans being considered paid first as required by law.

	Total	X	Y	Z
Net capital and loans	$75,500	$36,500	$23,000	$16,000
Loss which would eliminate Y	57,500	23,000	23,000	11,500
Balances	$18,000	$13,500	$ 0	$ 4,500
Additional loss which would eliminate Z	13,500	9,000		4,500
Balance for X	$ 4,500	$ 4,500	$ 0	$ 0

Solution 3

a. **Journal Entry**

Machinery—new	$155,637.50	
Allowance for depreciation	50,212.50	
Allowance for depreciation on appreciation	26,859.37	
Appreciation realized upon sale of asset (special income charge)	20,890.63	
Deferred interest expense	7,000.00	
Manufacturing expense	1,500.00	
Machinery—old cost		$77,250.00
Machinery—old appreciation		47,750.00
Accounts payable (machinery)		132,000.00
Payroll		2,400.00
Accounts payable—sundry		2,700.00

b. **Amount of Depreciation**

	Straight Line	*Sum-of-Years'-Digits*	*Double Declining Balance*
1955	$3,890.94	$ 7,411.31	$ 7,781.88
6	7,781.88	14,452.05	14,785.56
7	7,781.88	13,710.91	13,307.01

Computations—Old Machine

Depreciation on old machine — 13 years (13/20 x $77,250)	$50,212.50
Amortization of appreciation — 9 years (9/16 x $47,750)	26,859.37
Cost of machine	$77,250.00
Depreciation	50,212.50
Net book value of old machine	$27,037.50

Cost Basis—New Machine

Cash payment	$125,000.00
Book basis—trade-in	27,037.50
Labor—install new machine	900.00
Sales engineer—time	400.00
Sales engineer—expense	200.00
Freight in—new machine	1,100.00
Freight out—old machine (treated as reduction of trade-in allowance)	1,000.00
Total	$155,637.50

Computation of Depreciation—Sum-of-Years'-Digits

$$1 + 2 + 3 \ldots\ldots\ldots\ldots 20 = 210 \text{ periods or } \frac{1 + 20}{2} \times 20$$

10/210	($155,637.50) for first six months	$7,411.31
10/210	($155,637.50) for second six months	7,411.31
95/2100	($155,637.50) for third six months	7,040.74
95/2100	($155,637.50) for fourth six months	7,040.74
90/2100	($155,637.50) for fifth six months	6,670.17

Computation of Depreciation—Double Declining Balance

$155,637.50 × .05 =	$7,781.88
—7,781.88	
$147,855.62 × .10 =	14,785.56
—14,785.56	
$133,070.06 × .10 =	13,307.01

Solution 4

a. **S. BUILDING COMPANY, INC.**

Statement of Source and Application of Funds
For the Year Ended December 31, 1954

Funds provided:			
Net profit for the year		$173,500	
Add:			
Items not requiring an outlay of funds			
Depreciation	$30,000		
Fixed assets written off	10,000	40,000	$213,500
Issue of capital stock			50,000
			$263,500
Funds applied:			
Purchase of fixed assets		$280,000	
Retirement of mortgage		125,000	
Dividends paid		7,500	
Increase in utility deposit		800	413,300
Excess of funds applied (represented by a decrease in working capital)			$149,800

S. BUILDING COMPANY, INC.

Statement of Working Capital Changes
For the Year Ended December 31, 1954

	1954	*1953*	*Increase or (Decrease)*
Current Assets:			
Cash	$ 42,000	$129,000	$ (87,000)
Accounts receivable	133,000	85,500	47,500
Inventories	192,000	152,500	39,500
Prepaid expenses	21,000	14,000	7,000
Total	$388,000	$381,000	$ 7,000
Current liabilities:			
Accounts payable and accrued charges	$263,000	$220,850	$ (42,150)
Provision for income taxes	176,500	61,850	(114,650)
Total	$439,500	$282,700	$(156,800)
Working capital	$(51,500)	$ 98,300	$(149,800)

b.

S. BUILDING COMPANY, INC.

Statement of Cash Flow—For the Year Ended December 31, 1954

Expenditures:			
Purchase of fixed assets			$ 280,000
Retirement of mortgage			125,000
Dividends paid			7,500
Increase in utility deposits			800
For prepaid items			25,500
Purchases and expenses:			
Manufacturing costs	$2,607,000		
Increase in inventory	39,500	$2,646,500	
Selling and administrative costs		281,700	
		$2,928,200	
Net change in Accounts payable		42,150	2,886,050
Income taxes, 1953 accrual			61,850
			$3,386,700
Receipts:			
Proceeds from issue of capital stock		$ 50,000	
Cancellation of insurance		2,000	
Collections on sales:			
Sales	$3,300,000		
Less increase in Accounts receivable (See Schedule)	52,300	3,247,700	3,299,700
Excess of cash expenditures over cash receipts			$ 87,000

Reconciliation of Profit

Sales	$3,300,000
Cost of goods sold	2,650,000
Gross profit	650,000
Selling and administrative expenses	290,000
Operating profit	$ 360,000
Loss on sale of fixed asset	10,000
Net income before taxes	350,000
Income taxes	176,500
Net income	$ 173,500

Effect of Accounts Receivable on Cash Receipts

Gross balance 1/1/54 ($85,500 ÷ .95)	$ 90,000
Accounts charged off	2,300
Balance	$ 87,700
Gross balance 12/31/54 ($133,000 ÷ .95)	140,000
Sales absorbed in Receivables	$ 52,300

Cash Required for Manufacturing Costs

Total cost of goods sold		$2,650,000
Inventory increase		39,500
		$2,689,500
Deduct:		
Charges made for depreciation	$27,000	
Charges from prepaid insurance	4,000	
Charges from other prepaid items	12,000	43,000
Cash required		$2,646,500

Cash Required for Selling and Administrative Expenses

Total Selling and administrative		$ 290,000
Deduct:		
Charges made for depreciation	$ 3,000	
Charges from prepaid insurance	500	
Charges for loss on accounts	4,800	8,300
Cash required		$ 281,700

Cash Required for Prepaid Expenses

Balance 1/1/54		14,000
Write-off of insurance	$ 4,500	
Write-off of other prepaid items	12,000	
Insurance cancelled	2,000	18,500
Excess of write-offs over balance		$ 4,500
Balance 12/31/54		21,000
Cash required		$ 25,500

Computation of Cost of Providing for Loss on Accounts

Reserve 1/1/54	$ 4,500
Charge-offs during year	2,300
Balance	$ 2,200
Reserve 12/31/54	7,000
Provision for loss on accounts	$ 4,800

Auditing

November 3, 1955; 9 a.m. to 12:30 p.m.

Solution 1

a. There are three conditions under which an auditor may qualify his opinion on financial statements. He may qualify because of failure to follow generally accepted accounting principles; he may qualify because of lack of consistency in application of principles; or he may qualify because of the scope of his audit. The qualification may be applicable to the balance-sheet and income statement or only to one of the statements. Qualifications because of lack of consistency usually apply to the income statement and comparative balance sheets. Qualifications as to scope of the audit usually apply to both statements.

The auditor will disclaim an opinion when he has not been able to form an opinion because of the limited scope of his audit, or when the accounting principles followed do not fairly present the financial position or the income and a clear explanation of the effect of the departures from accepted principles is not possible.

Basically the decision as to whether to qualify or to disclaim is a matter of considering the nature and extent of the exceptions. In instances where an unqualified opinion cannot be expressed, the auditor must weigh the qualifications or exceptions to determine their significance. If they are such as to negative the opinion, he should state that he is not in a position to express an opinion on the financial statements taken as a whole, and he should indicate clearly his reasons therefor.

b. Since an auditor cannot effectively control the use made of financial statements accompanied by his name or on his stationery, the adoption of practices which will minimize the possibilities of uncertainties and misinterpretations by third parties is obviously to the interest of all concerned. The Institute's Committee on Auditing Procedure, therefore, recommends that, whenever financial statements appear on the stationery or in a report of an independent certified public accountant, there should be a clear-cut indication of the character of the examination, if any, made by the accountant in relation to the statements, and either an expression of opinion regarding the statements, taken as a whole, or an assertion to the effect that such an opinion cannot be expressed. When the accountant is unable to express an over-all opinion, the reasons therefor should be stated.

Since the comment "for management purposes only" does not clearly indicate the character of the examination made, a more specific disclosure of the extent of the examination, if any, is required to avoid the possibility of persons using the statements attaching incorrect significance to them.

Solution 2

a. The problem of reporting on the affairs of a business where the owner has other business activities is created by both legal and economic considerations. Legally the business is not separate and distinct from the owner's other affairs. Creditors of the business may not have preference over other creditors as to the assets of the business. As a practical matter, the proprietor may not keep his affairs completely separate and he may not operate the business as an economic entity at all times. For these reasons some accountants will not express an opinion on a portion of the activities of a sole proprietor.

If a report is to be given, it must clearly set forth the ownership of the business and the limited scope of the report.

a. Such a report might be as follows:

I have examined the balance sheet of A. O. C. Truck Lines as of December 31, 195-, and the related statement of income for the year then ended. My 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 I considered necessary in the circumstances.

A. O. C. Truck Lines is wholly owned by A. O. C. as an individual. The statements of the Truck Lines reflect the transactions of that business only and do not include assets and liabilities which Mr. A. O. C. has in his other business activities, nor do they include any provision for the personal income taxes of Mr. A. O. C.

(*After making the above disclosure, some accountants would give an unqualified opinion, others would give a qualified opinion, and some would not express an opinion. Concluding paragraphs under the last two views as to appropriate action follow.*)

No Over-all Opinion

Because of the possible effect of the other business affairs of Mr. A. O. C. on the A. O. C. Truck Lines, I am unable to express an opinion on the financial statements. However, nothing came to my attention in the course of my examination which indicated that the statements of the Truck Lines have not been prepared in conformity with generally accepted accounting principles as applied to that portion of the operations, assets and liabilities of Mr. A. O. C. used in the Truck Lines business.

Qualified Opinion

In my opinion, subject to the possible effect of the other business activities of Mr. A. O. C., the accompanying balance sheet and statement of income present fairly the financial position of A. O. C. Truck Lines at December 31, 195-, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

General Comments on Questions 3 to 8, Inclusive

Since these questions are based on much more extensive information than is commonly included in Auditing questions, it is important to decide what would be expected of a candidate in preparing his answers.

The general instructions indicate that the audit program is to be specifically tailored to the existing processes, procedures and controls as described for the Black Biscuit Company. Therefore, it seems probable that each program should make specific reference to the particular records, books and accounts to be used in the audit.

For a program to be satisfactory it should state what is to be done and not merely state an objective. For instance, the statement "determine that the allowance for doubful accounts is adequate" does not seem to be specific enough in response to these questions. The program should state how *to accomplish that objective.*

Also the instructions point out that answers will be rated on the adequacy of the procedure and the reasonableness of the total program in view of the existing internal control. This appears to require a fairly specific indication of the extent of various tests that are proposed. If the tests are unreasonable under the circumstances, grades will be reduced because of such excessive work.

Another important element of the requirements of these questions is that the program be separated between interim examination and year-end examination, with as much of the work done at the interim date as is feasible. Since many commonly used textbooks do not devote much attention to the possibility of doing a considerable portion of the audit work at some date in advance of the year-end, students may find the following comments helpful in separating an audit program into interim and year-end work.

Interim work can be utilized in several ways to save time at year-end. In a situation such as this, where internal control is generally good, most of those tests that should be made of the accounting procedure and records to establish that the procedures are actually being effectively followed can be made as a part of the interim work. Therefore, we would expect the interim program to include sufficient tests to establish that the controls described are actually operating.

The interim work also is utilized to complete for the year to date analyses of accounts and tests to supporting records of items which normally are audited in that manner. For example, in doing interim work it is common to make an analysis of the fixed asset accounts from the first of the year up to the date of the interim examination and to vouch major additions and retirements. That work can be done as effectively at the interim date as at the year-end.

Also during the interim work it may be economical to review and discuss with the client all changes in operations and in accounting practices and policies that have taken place during the year; to make such tests of the opening balances as are necessary; to review contracts that have been made during the year; and to complete plans for the year-end examination.

The suggested programs that are presented for each of the questions are somewhat more extensive than would be essential under the facts given, but still they *do not include all steps which might be reasonably taken under the circumstances. Within limits, the extent and type of examination that is made can never be completely stated in advance. These are matters for the judgment of the accountant performing the engagement, and only the broad limits of maximum and minimum amounts of work that would be dictated by sound judgment can be prescribed. Also it must be recognized that the amounts and kinds of evidence required to permit forming an opinion on financial statements will vary as between accountants. For this reason no single "correct" program can be stated in a particular case.*

Probably in appraising a program, consideration would have to be given to how well it fits the existing situation as described, whether it includes all major and essential procedures, and whether it is well balanced from the standpoint of the reasonableness of the time required to carry out the steps.

Solution 3

Accounts Receivable

Control over Accounts receivable appears to be adequate except for two elements. The accounts with institutions are handled almost exclusively by one person, the president. He accepts orders, sets prices and approves adjustments of accounts. However, he is one of the two owners of the business.

The second element is that the procedure for collection of accounts permits the secretary-treasurer, who is responsible for cash receipts, to approve adjustments of accounts where invoices are not paid in full.

Interim examination: Obtain from client an aged trial balance for all ledgers for the month just ended.

Test footings and check totals to the subsidiary controls and balance the subsidiary controls with the general ledger control account. Make a limited test of individual balances from customers' invoices, credit memos and adjustment slips in trays. Reconcile balances paid since the month-end from customers' cash receipts record and the invoices, credit memos and adjustment slips attached. Make tests to establish that postings are current. Test from sales orders through the invoices to the ledgers to determine that a satisfactory sales cut-off is made.

Select accounts for confirmation, taking into consideration the selections made in prior years. The average account balance of the salesmen's accounts is about $260 ($341,225 divided by 1,500 accounts).

Depending on prior selections either select all accounts having balances of over $1,000 and about 5 per cent to 10 per cent of smaller accounts or select two or three trays for positive confirmation. Include all past-due balances and all doubtful accounts.

Confirm all accounts with institutions on a positive basis. Arrange for client to prepare open-item statements and confirmation requests for accounts selected. Account for the number of confirmation forms given to client, check amounts thereon to trial balances and open-item statements. Number the confirmation requests and mail in envelopes bearing our return address, together with statements and our own return envelopes.

After two weeks, prepare and mail second requests to customers who have not yet replied.

When confirmation replies are received, note that postmarks on envelopes agree with addresses on confirmation request forms. Investigate differences by reference to correspondence, etc., to determine if customers are located in the cities indicated by the postmarks. Investigate all requests returned by post office because of improper address, etc. On accounts for which no replies are received to second requests, check subsequent payments, shipping documents and other evidence to determine the validity of accounts and balances.

Prepare an analysis of the results of the circulation tests.

Scan all subsidiary controls for write-offs and adjustments. Review the cash receipts record for credits. Investigate unusual items and a number of other items to determine the reason for adjustment or write-off. Make tests of discounts, returns and other credits shown in cash receipts. If necessary, discuss items with the president.

Prepare an analysis of the allowance for doubtful accounts control. Test or tie-in charges with credits to accounts receivable and debits to expense accounts. Review correspondence or other evidence to determine validity. Give particular attention to accounts with institutions. Have a list of charge-offs prepared to submit to the president.

Year-end examination: Analyze from the general ledger the changes in the accounts receivable control account for the period from the interim examination date to the year-end. Tie-in the sales, discounts, returns and allowances postings to related general ledger profit-and-loss accounts. Test the cash receipts postings to cash book. Review any other debits or credits of an unusual nature or large amount and check to supporting documents.

Obtain from client an aged trial balance of accounts receivable. Foot several to the nearest $10 and cross-foot the totals of the aging columns. Check the trial balances from the customers' invoices, credit memos and adjustment slips in trays and test-check the aging of the accounts, say every tenth account. List payments made the last few days subsequent to year-end and trace to the customers' cash records. Check sales, shipping and billing cut-off at year-end.

Check the amount of customers' credit balances transferred to current liabilities.

Compare the year-end trial balances with interim ones and request confirmation of accounts having exceptionally large balances which were not circularized at the interim examination.

Investigate the collectibility of advances to salesmen.

Complete your analysis of write-offs and adjustments of accounts. Tie-in the provision to the income account. Test the adequacy of the allowance for cash discounts. Make tests of rebates and tie-in the total to the expense account.

Obtain a representation letter from the president and secretary-treasurer covering the accounts receivable and the adequacy of the allowance for losses.

Solution 4

INVENTORIES

The internal control over inventories appears to be adequate to permit reliance on limited testing of inventories.

Interim examination: The primary purpose of the interim work is to determine the actual operation of the control procedures.

Balance the major perpetual inventory records with their controls and tie-in to the general ledger control accounts.

Compare some of the weekly physical counts with the detail ledger, examine adjustment slips and check to the ledger. Obtain explanations of any major differences and determine whether the client consistently attempts to determine the reason for differences.

Make tests of transactions recorded on the perpetual records for some major items as follows:

Check some debits back to the purchase orders, receiving tickets, and invoices, comparing quantities and prices.

Test freight charges to purchase order for terms, tie-in to receiving records and check to invoices.

Scan the credits as to pricing-out of issues.

Test extensions for approximate accuracy.

Investigate the cost system including allocation of overhead to determine that results are reasonable and that quantities and prices entered in finished goods are correct.

Scan major items of inventory, especially packaging material to determine turnover and possible obsolescence.

Scan the month-end inventories for the year. Note and investigate any unusual variations. Scan the inventory control accounts for any unusual adjustments.

Year-end examination: Arrange to be present and observe taking of the physical inventories. Count about twenty items of varying values in each department. Obtain copies of final inventories and test from original count sheets including all items personally counted. Compare quantities on perpetual record with physical count for all items of over $1,000 and for some smaller items. Determine that quantity adjustments are made and that the control accounts are adjusted.

Make tests of receiving records, shipping records and issues to production for the last few days of the year and the first few days of the next year to determine that the "cut-off" was satisfactory.

Compare closing inventory with interim inventories and account for any significant variations.

Compare market prices with inventory cost prices on major "purchased inventory" items and check the accuracy of any write-down. Obtain some recent invoices for major items and compare prices with the prices shown on the inventory cards.

Compare unit selling prices of major finished goods inventories with unit costs of such items to see if any adjustment of inventory prices is required.

Discuss slow-moving or obsolete stocks with the vice president and secretary-treasurer. In view of the large inventory of packaging materials in relation to usage, give particular attention to major items in that group.

Obtain a representation letter, signed by the president, vice president, and secretary-treasurer covering the inventories.

Solution 5

CURRENT LIABILITIES

The internal control over current liabilities seems to be adequate, excepting the functioning of the president in handling invoices not on the prescribed forms.

Interim examination: Analyze taxes payable, tying-in payments to the 1/1/55 accruals. Tie-up the credits to expense accounts to date. Test to tax receipts and other documents.

Check major payments of real estate taxes to receipted tax bills and compare assessed values with book amounts.

Check major payments of federal and state income taxes to copies of tax returns and to cash disbursements records. Review copies of the latest tax returns filed as well as status of prior years' returns. Obtain revenue agent's report and review for significant features.

Analyze the dividend payable account to date. Tie-in payments to January 1 accruals and cash disbursements record, and retained earnings account. Review the minutes for approval of the accruals and payments, including all dividends declared during the current year.

Analyze the bonus payable account to date. Tie-in all payments to accruals of January 1 and cash disbursements record. Test the computation of the bonus credits and determine that they are in compliance with the terms of the bonus plan. Examine the minutes for approval of the bonus credits and payments, including those made during the current year.

Analyze wages payable account to date. Determine that balance at January 1 was properly accrued and paid, with tie-in to payroll and cash disbursements records. Tie-in credits to date to proper expense accounts, and charges to cash disbursements records.

Review cash disbursements, journal voucher register and the voucher register for the first two weeks of January 1955 to determine that there were no significant unrecorded liabilities as of the first of the year.

Year-end examination: Complete all analyses begun during the interim work.

Obtain from the client a trial balance of the open items in the voucher register, foot and trace the total thereof to the general ledger control account. Note on trial balance those vouchers subsequently paid. If vouchers were not paid in accordance with the payment terms, investigate the reason thereof. Examine vouchers and supporting documents of about 25 of the major or unusual vouchers payable. Determine that payments made after December 31 were not debited to accounts in the current year.

Obtain from company's attorneys confirmation of any unpaid fees due them and compare amounts with liabilities accrued. Also obtain a description of litigations pending against the company, if any, and an opinion as to the possible loss.

Mail confirmation forms requesting statements of account balances at December 31, 1955 from major suppliers. Have client reconcile and explain differences between unpaid vouchers and creditors' statements and verify their reconciliations.

Complete analyses to December 31, 1955 for salaries, wages, commissions, dividends, and bonus payable. Tie-in the analyses to the expense accounts. Make tests of the correctness of the balance of the accruals. Where possible, check to subsequent payment of the balance.

Complete analyses of taxes payable, showing by types of taxes the amounts accrued at December 31, 1955, amounts of provisions and payments during the year. For income taxes review the computations supporting the accrual. Determine that the principle followed is consistent with that of the preceding year. Tie provisions into expense accounts.

Search for unrecorded liabilities by scanning the voucher register and examining all vouchers over $1,000 recorded for January, 1956. Review the January cash disbursements book and trace items over $1,000 to the voucher register to determine that they have been entered as vouchers. Review journal vouchers entered in January, 1956.

Check dividends payable to the minutes of the board of directors meetings and prove with stock outstanding.

Obtain a letter signed by the president and secretary-treasurer covering liabilities.

Solution 6

SALES

The internal control is good except over sales made to institutions and except for the great freedom permitted in adjustment of account balances by the secretary-treasurer. Special attention to sales to institutions seems to be warranted because of the president's sole control over them.

SALES AND REVENUES:

Interim examination: Obtain from the statistical department monthly summaries of sales to date. Check the total amounts to the sales and to accounts receivable control accounts in the general ledger.

Select one day's invoices per month from the beginning of the year from files in the order department. Determine that properly completed order/shipping memos are attached and that all numbers are accounted for. Tie up the invoices with the daily summary sheet. Spread by salesmen on peg boards and check to distribution summaries in statistical department. Trace the quantities to cost of goods sold records and perpetual inventory cards.

Make some test of support for sales to institutions paying particular attention to sales made at less than list minus 10 per cent. Determine the apparent reason for some of these sales by discussion with officers and employees.

Investigate some of the accounts showing frequent or large returns. Check the return credits with receiving tickets and into stores.

Determine the approximate amount of adjustments or allowances authorized by the secretary-treasurer. Examine correspondence and other information concerning some of these adjustments. Check some of the charges arising from non-salable returns, obtaining explanations of any unusual items.

Make a test of production of one item through inventory and into sales using production reports and shipping records.

Year-end examination: Obtain monthly summaries of sales from the interim examination to year-end. Check the total amounts to the sales and accounts receivable control accounts in the general ledger. Look for irregularities.

Working from invoice files in order department, account for the continuity of sales invoice numbers from December 26, 1955 to January 5, 1956 and examine shipping dates on attached documents; determine that the copy is in the accounts receivable tray or, if paid, filed with cash receipts records. (See cut-off under accounts receivable.)

Compare monthly sales for the current year with comparable sales for preceding year and obtain satisfactory explanation of any major changes. Make a separate comparison of sales to institutions.

Compute percentage of gross profit for the year and compare with the preceding year. Compute percentage of gross profit on a few major lines of biscuits and compare with preceding year. Obtain satisfactory explanations of any significant variations.

Examine unshipped orders and back-orders in order department and satisfy yourself that none have been shipped and not billed. Check to see if there are any unbilled orders in finished goods/stores shipping department.

Solution 7

Payrolls

The internal control over payrolls seems to be satisfactory. The control over unclaimed payroll checks might be improved.

Interim examination: Foot the payroll sheets for the last week of the month completed before your examination. Check payroll distribution for the week to cost records.

Select twenty employees' names from the plant payroll sheets and ten names from the office salaries sheets and check them to the employment record cards and the rate adjustment slips. Prove the weekly time of these plant employees with the "foreman's time book," noting department and operation which are charged.

Trace earnings to individual earnings records and compare endorsements on pay checks to W-4 statements.

Check officers' salary rates to the minutes of the Board of Directors.

Prove the extensions of the gross payrolls for one month. Compare payroll deductions with employees' authorizations on employment record cards, and make test-checks of computed deductions. Tie-in deductions for one month with the related liability accounts.

Trace the payrolls for a month together with distributions to the monthly summary, foot the summary and trace the totals to the general ledger and to the cost accounting control accounts.

On a Thursday during the period of your examination, list all factory payroll checks and observe the distribution of them by the cashier's office. See that all employees are wearing badges as required. List any unclaimed checks and investigate the reasons therefor. Observe the distribution of these checks when the employees return to duty. Investigate any unclaimed checks for prior pay periods.

Year-end examination: Scan payrolls for period since the interim examination. Test or recompute the accrual at year-end. Check the subsequent payment in total and tie-in with charges to costs and expense.

Compare the total payrolls with those for the prior year, taking into consideration the change in volume of sales.

Solution 8

Manufacturing Costs

The internal control over manufacturing costs appears to be satisfactory.

Interim examination: Examine daily reports from production and stores department for the month just completed, test-check prices, extensions, distributions and approvals. Make tests of postings to perpetual inventory records and cost records.

Review the basis of applying overhead and see if it is consistent with prior year. Discuss any changes with the vice president.

Obtain an analysis of overhead for the year to date. Vouch unusual items and a representative number of other items to supporting documents. Review the accounts, looking for items which are not appropriate charges to current year's overhead.

Obtain total production figures for one month and a breakdown of costs, if available. Tie cost to control accounts in cost ledger, and tie the quantities for major items into finished goods inventory cards. Check payroll summaries to cost ledger and test charges to current year's overhead.

Establish the unit costs of five major lines of biscuits. Check with prior month's and prior year's cost figures for these same lines and obtain explanations of major differences.

Compare the unit costs of production for major lines with selling prices, obtaining explanations for large variations in margin of gross profit.

Year-end examination: Review the accounts since the date of your interim examination. Check the year-end cut-off from stores and into finished inventory by testing the stores' requisitions and the production reports for one or two days before and after the year-end. Review the general, administrative and selling expenses that should have been charged to cost of goods sold. Account for significant variations in types of expenses.

Commercial Law

November 4, 1955; 9 a.m. to 12:30 p.m.

GROUP I

Solution 1

a. The necessaries must be suitable to the condition in life of such infant and to his actual requirements at the time of delivery. (Uniform Sales Act, §2)

b. The Uniform Sales Act provides that, unless the context or subject matter otherwise requires, the term "goods" includes all personal chattels other than things in action or money, and that it also includes emblements, industrial growing crops and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale. (Uniform Sales Act, §76(1))

c. The Uniform Sales Act describes future goods as goods to be manufactured or acquired by the seller after the making of the contract to sell and provides that where the parties purport to effect a present sale of future goods, the agreement operates as a contract to sell the goods. (Uniform Sales Act, §5(1) and (3))

d. Yes. The Uniform Sales Act provides that a thing is done "in good faith" within the meaning of the Act when it is in fact done honestly, whether it be done negligently or not. (Uniform Sales Act, §76(2))

Solution 2

a. Yes. An account receivable may be assigned and, as between the assignor and assignee, it is not necessary that notices be given to the debtors to validate the assignments. However, the debtors would become discharged if they paid the assignor without notice of the assignment. (Restatement of Contracts, §151; Williston on Contracts (rev. ed., 1936), §412, 430; 4 Am. Jur. Assignments, §98)

b. No. In order for the assignment to be valid as against the obligor the latter must have received notice of the assignment. (Restatement of Contracts, §170)

c. There is doubt as to whether the assignments were valid as to creditors. It is settled that if an assignor of accounts receivable is permitted to retain unfettered dominion and control over the receivables and the right to use the proceeds in his business, the assignment is void as to creditors because considered fraudulent in law as to them. *Benedict* v. *Ratner,* 268 U.S. 353 (1925). The exact nature of the type of restriction required to avoid the application of this rule, as it has been interpreted by the courts, is not certain. The rule does not apply if the borrower, as agent of the lender, collects the assigned accounts and immediately after collection, either remits the amount collected to the lender or deposits it in a separate account for the lender and renders an accounting. Also the rule is not applied if, on collection of the accounts, the borrower immediately assigns to the lender new accounts at least equal in amount to those collected or segregates in a separate earmarked account the funds collected and holds them in a fiduciary capacity for the lender until other accounts in amounts at least equal to those collected are assigned. Here the facts do not fall within either of the types of restriction outlined above. According to the question, the proceeds of the accounts as collected were not segregated and were deposited by the borrower in his checking account, thus putting the borrower in the position of being free to use the proceeds in his business at least until the lapse of about two weeks when he would give the lender his personal check for an amount equal to the proceeds of the collected accounts. On these facts there are authorities which appear to support the view that the assignments would be void as to creditors and there are also authorities which appear to support the view that the assignments would be valid as to creditors. (In re *Lambert* v. *Braceland Co.,* 20 F.2d 758; In re *Helfenbein,* 32 F.Supp. 26; *Parker* v. *Meyer et al.,* 37 F.2d 556; *Union Trust Company of Maryland* v. *Peck,* 16 F.2d 986 and 44 Yale Law Journal 639 at p. 645.)

Solution 3

a. No. Specific performance is not available to enforce a contract which involves an executory promise to render personal services. When specific performance is granted, both parties are required to fulfill their promises. Although a court could easily supervise the performance of the corporation's promise to pay money, it would not be administratively feasible for a court to attempt to supervise the performance of Spark's promise to render personal services. (Corbin, Contracts (1951), §1184, 1204; 49 Am. Jur., Specific Performance §134-137)

b. It is not necessary to bring periodic suits for salary installments as they fall due. Where a party bound by a wholly executory or partially executed contract repudiates his obligation before the time of performance, the promisee has, according to the great weight of authority, an option to treat the contract as ended so far as further performance is concerned, and to maintain an action for the damages occasioned by such anticipatory breach. (Corbin, Contracts (1951) §958)

c. The general rule is that the plaintiff is entitled to a sum of money which will compensate him for the actual loss or injury which he suffered as a result of the breach, so as to put him in as good a position as he would have been in had the contract been fulfilled. Generally, where the consideration to be paid by the defendant is a sum of money, this amount is the amount of the contract price which the plaintiff would have received if the contract had been fulfilled, less matters considered in mitigation. In the case of an employment contract, as here, the compensation Sparks could have earned with reasonable effort and diligence in comparable employment during the remainder of the contract period would be deducted from the unpaid agreed compensation in mitigation of damages. (Corbin, Contracts (1951) §958; Restatement of Contracts; §329, 35 Am. Jur., Master and Servant §57)

Solution 4

a. 1. Yes. The Uniform Negotiable Instruments Act provides in Section 19 that the signature of any party may be made by a duly authorized agent.

2. Yes. Section 18 of the Act provides that one who signs in a trade or assumed name will be liable to the same extent as if he had signed in his own name.

3. Yes. However, it should be noted that although Section 22 of the Act provides that endorsement by an infant has the effect of transferring title to the instrument, nevertheless the infant may disaffirm the endorsement and recover the instrument from the endorsee and some authorities have held he may recover it from a holder in due course. Also he may successfully plead his infancy as a defense against a suit by a holder including a holder in due course. (8 Am. Jur., Bills & Notes, §333, 614)

4. Yes. He may endorse the instrument with the incorrectly spelled name and, if he wishes, then endorse his correct name. Also it should be noted that slight variations between the name of the payee as it appears in the body of the instrument and as it appears in the signature affixed as an endorsement will not have any legal effect to prejudice the rights of the parties to the transfer. (8 Am. Jur., Bills & Notes, §317)

b. No. Section 32 of the Act requires the endorsement to be an endorsement of the entire instrument and provides that an endorsement which purports to transfer to the endorsee a part only of the amount payable does not operate as a negotiation of the instrument. Of course an instrument which has been paid in part may be endorsed as to the residue.

c. Section 130 of the Act provides that where the drawer and the drawee are the same person the holder may treat the instrument, at his option, either as a bill of exchange or a promissory note.

d. Section 129 of the Act provides that an inland bill of exchange is a bill which is, or on its face purports to be, both drawn and payable within the state and that any other bill is a foreign bill. It also provides that unless the contrary appears on the face of the bill, the holder may treat it as an inland bill.

Solution 5

a. Yes. Section 10(1) of the Uniform Partnership Act provides that where title to real property is in the partnership name, any partner may convey title to such property by a conveyance executed in the partnership name, but provides further that the partnership may recover the property unless:

1. The partner in so signing was apparently carrying on in the usual way the business of the partnership, or
2. The partner so signing had in fact no authority to act for the partnership in the particular matter, and the person to whom he conveyed the property had knowledge of the fact that he had no such authority, or

3. The property has been conveyed by the grantee or a person claiming through such grantee to a holder for value without knowledge that the partner, in making the conveyance, had exceeded his authority.

   In regard to the exception listed in subparagraph (1) above, it should be noted that a partner in a firm engaged in the business of buying and selling land would normally be apparently carrying on the firm's business in the usual way if he executed the deed in the name of the firm. However there might be a different result if the firm's business were manufacturing and its only plant were the real estate so transferred.

b. Section 10(5) of the Act provides that where title to real property is in the names of all the partners, a conveyance executed by all the partners passes all their rights in such property.

c. 1. Section 18(d) of the Act provides that in the absence of agreement, a partner shall receive interest on the capital contributed by him only from the date when repayment should be made.
2. Section 18(c) of the Act provides that in the absence of agreement, he shall be paid interest from the date of an advance made beyond the amount of capital he agreed to contribute.
3. Section 18(f) of the Act provides that in the absence of agreement no partner is entitled to remuneration for acting in the partnership business, except that a surviving partner is entitled to reasonable compensation for his services in winding up the partnership affairs.

d. 1. Section 31(4) of the Act provides that dissolution of the partnership is caused by the death of a partner.
2. Section 25(2) of the Act provides that on the death of a partner, his right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, when his right in such property vests in his legal representative. The section mentioned also provides that such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but a partnership purpose.

Solution 6

a. It is of importance for the trial court to determine whether the debt was unliquidated or disputed in order properly to apply the rules applicable to consideration. In order that the acceptance of the check operate as a discharge, it must appear that the payor has suffered some detriment by issuing the check and thus has furnished consideration for the agreement accepting the check as payment in full. If the debt was either unliquidated or disputed, issuance of the check would be furnishing consideration for the discharge. However, if the debt were in the liquidated amount of $200 and there were no dispute as to liability, payment of $100 would entail no detriment to the debtor and would not constitute furnishing consideration for the discharge. (Williston, Contracts (rev. ed., 1936), §128) *b.* 1. A composition with creditors is an agreement between an insolvent or embarrassed debtor and his creditors, whereby the creditors for some consideration, such as an immediate payment, agree to accept a dividend less than the whole amount of their claims to be distributed pro rata in discharge and satisfaction of the whole debt. (11 Am. Jur., Composition with Creditors, §1)

2. Yes. Such an agreement, if entered into by a debtor with a number of his creditors, each acting on the faith of the engagement of the others, will be binding on them, for each in that case has the undertaking of the rest as a consideration for his own undertaking. A common fund is secured for the advantage of all, and the beneficial consideration to each creditor is the engagement of the rest to forbear. (11 Am. Jur., Composition with Creditors, §4)

3. It is not essential that the agreement include all the creditors or that it have the assent of all creditors unless the agreement so provides. (Corbin, Contracts 1951, §1283)

c. Detriment means giving up something which immediately prior thereto the promisee was privileged to keep or the doing or refraining from doing something which immediately prior thereto he was privileged to either refrain from doing or do. (Williston, Contracts (rev. ed., 1936), §102A)

A benefit to the promisor or a detriment to the promisee is sufficient consideration for a contract. (12 Am. Jur., Contracts, §79)

Solution 7

a. 1. In the absence of agreement to the contrary the bank, as pledgee, is entitled to collect the coupons of the bonds as they mature and hold the proceeds as additional security. (Restatement, Security, §3, Illustration 1)

However, a prior course of conduct between the parties may be such as to warrant the inference that the pledgee has agreed to permit the pledgor to collect and keep the interest on the bonds. Moreover, the custom is for a bank to permit the pledgor to collect and keep the interest on the pledged bonds.

2. This would appear to depend on the terms of the debt. If matured and unpaid, presumably the pledgee could apply to the debt any income on the bonds collected by it. However, if the debt is not due and no interest thereon is due and unpaid, then, in the absence of an agreement to the contrary, the pledgee is entitled to hold the collected income as additional security. (Restatement, Security, §3, Illustration 1, and §27)

b. As to the deposit of $1,000.00, the money deposited became the property of the bank and the relationship of the bank to the depositor became that of debtor and creditor. Accordingly, as to this deposit the depositor would be merely a general creditor. As to the bundle of 50 one-hundred-dollar bills, the bank merely assumed charge or custody of property without authority to use it and the depositor was entitled to the return of the identical money deposited. Accordingly, as to the bundle of bills, the right of property remained in the depositor and the relationship created was that of bailor and bailee rather than that of creditor and debtor. The receiver would be obligated to return the bills. (7 Am. Jur., Banks, §446)

Solution 8

a. 1. No. In the case of a stock dividend, normally until the formalities required as conditions precedent to the increase in the corporation's capital have been completed, the stockholder does not become entitled to anything and the mere declaration of the dividend does not give him a vested right. However if the dividend is payable in shares of the corporation's stock it has purchased out of its earnings, the rule precluding rescission may not apply as no increase in authorized capital is involved. (Fletcher Cyc. Corporations, §5323)

2. The general rule is to treat the proceeds of the preemptive right as principal. Also the Uniform Principal and Income Act provides that such proceeds shall be treated as principal. (Scott on Trusts (1939), §236.9; Bogert on Trusts (1935), §854; §5(2) of Uniform Principal and Income Act)

b. 1. No. The majority rule is that there cannot be a corporation de facto created under a statute which is unconstitutional, as an unconstitutional law is absolutely void. There is a minority view to the effect that such a statute is presumptively valid until declared to be invalid and that until so declared, as against the public who have acted in reliance on the presumption, there is a de facto corporation whose acts are valid. (Fletcher Cyc. Corporations (1932), §3790, 3791)

2. Yes. A promoter may not retain a secret profit made by him in violation of the duty he owes to the corporation for open and fair dealing. Here the facts as to the secret profit were not disclosed by him to the board of directors or other stockholders as required by the affirmative duty of disclosure imposed upon him because of his fiduciary relationship. (Fletcher Cyc. Corporations, §193, 194; 13 Am. Jur., Corporations, §115-121)

3. No. A fundamental variance from the express stipulations of the subscription contract will vitiate it. Here, there is such a fundamental variance in that the authorized capital stock was 50% more than that stated in the subscription contract. (13 Am. Jur., Corporations, §237; Fletcher Cyc. Corporations, §1435)

Solution 9

1. An estate in joint tenancy is one held by two or more persons jointly with equal rights to share in its enjoyment during their lives and having as its distinguishing feature the right of survivorship by which on the death of any tenant, the entire estate goes to the survivor or survivors. (14 Am. Jur., Co-tenancy, §6)

2. An estate in tenancy in common is one whereby two or more persons own individual fractional interests in the property with no right of survivorship. On the death of a tenant in common, his undivided interest descends to his heirs. (14 Am. Jur., Co-tenancy, §15, 16)

3. In some states there are laws recognizing what is known as "community property." Speaking very generally, these laws provide that property owned by each spouse before the marriage remains his or her separate estate, while all that is acquired during the marriage, otherwise than by gift, descent or devise, becomes the joint property of the married couple and is known as community property. (11 Am. Jur., Community Property, §1)

4. A tenancy for years is an estate which is limited for a certain time, as for a year, for half a year, for a quarter, or for any greater or lesser period of fixed duration. (Tiffany, Real Property, 3rd ed., §72)

5. A tenant at sufferance is one who entered under a lease for years and wrongfully retained possession beyond his term. (Tiffany, Real Property, 3rd ed., §174)

6. An abstract of title is a condensation of the recorded history of the title to land, consisting of a synopsis or summary of the material or operative portion of all the conveyances which affect the title, with a statement of all recorded liens, charges or liabilities to which it may be subject. (Black, Law Dictionary, 3rd ed., p. 17)

7. An escrow agent in the commonly accepted use of the term is one with whom a written instrument, such as a deed, contract or negotiable security, is deposited for holding until the performance of a condition or the happening of a certain event. (19 Am. Jur., Escrow, §2, 8)

Solution 10

a. The purpose of the Federal Trade Commission Act is to prevent unfair methods of competition in commerce and unfair or deceptive practices in commerce by creating a commission with power to order those engaging in such methods and practices to cease and desist. (15 U.S.C. 45, as amended)

b. Yes. The Federal Trade Commission would be justified in ordering the company to cease and desist with respect to such advertising. (*E. Griffiths Hughes, Inc., v. Federal Trade Commission,* 77 Fed. 2nd 886 (1935); certiorari denied 296 U.S. 617)

c. A consent decree is a judgment entered by consent of the parties, frequently as a result of a compromise. In the absence of fraud it is binding and conclusive upon the parties. (31 Am. Jur., Judgments, §458, 464)

Solution 11

a. (1) False. (Uniform Sales Act, §44 (2)
(2) True. (Uniform Sales Act, §69(1)(b))
(3) True. (Uniform Sales Act, §57)

(4) True. (Uniform Sales Act, §15 (5))
(5) False. (Uniform Sales Act, §19)
(6) False. (Uniform Sales Act, §19, Rule 4 (1))
(7) True. (Uniform Sales Act, §19, Rule 3 (1))
(8) True. (Uniform Sales Act, §16 (a))
(9) False. (Uniform Sales Act, §24)
(10) True. (Uniform Sales Act, §56 (1)(b))

b. 1. (d) If, under the guise of a contract which has the appearance of validity on its face, the real intention is merely to speculate on the rise or fall of the market, without any purpose that any property shall be delivered or received but with the understanding that at the appointed time the account is to be adjusted by paying and receiving the difference between the contract and the current price, then the contract is a wagering or gambling contract and void. (24 Am. Jur., Gaming and Prize Contracts, §66)

2. (b) While a party may not by contract relieve himself of a duty imposed upon him by law, and courts do not favor contracts relieving liability for negligence, a contract between most private parties, if of relatively equal bargaining positions, relieving one of them of liability for injury to the other caused by negligence, will ordinarily be enforced by most courts. Some parties, such as common carriers, whose activities are affected with the public interest, cannot obtain enforcement of such an agreement, in dealing with any party. (Prosser on Torts, p. 380; 38 Am. Jur., Negligence, §8)

3. (b) (Williston, Contracts, rev. ed., §1636)

4. (a) The rule rests upon the broad ground that no court will allow itself to be used when its judgment will consummate an act forbidden by law. Such agreements cannot be enforced by one party against the other, either directly by asking the court to carry them into effect, or indirectly by claiming damages or compensation for breach. Nevertheless, frequently some legal effect is given to illegal agreements under some circumstances. (12 Am. Jur., Contracts, §209)

Theory of Accounts

November 4, 1955; 1:30 to 5 p.m.

Group I

Solution 1

The proposal to state the policy at its cash realizable value of $600 is based on the liquidating theory of showing assets. It is not acceptable when applied to prepaid items in a going concern where costs are generally apportioned over the periods benefited. It would be acceptable for a business that is liquidating. Use of the $600 value would charge a greater cost to past periods than to the future year for the same benefit. The result would be a transfer of $400 of income from 1953 and 1954 to 1955.

The proposal to state the policy at $1,000 is the usual procedure for a going concern. It is based on apportionment of a lump-sum cost to the periods benefited in a systematic manner, in this case on the straight-line method. Following it will produce equal charges against income in each year based on equal benefit.

The proposal to state the policy at $1,200 may rest on acceptance of the concept that a period should be charged with the cost that would be necessary if the business were starting anew each period. It is not an acceptable procedure for prepaid items in a going concern. It would result in unequal charges against income. The 1955 operations would be charged more than 1954, which would have been charged more than 1953.

Solution 2

Various factors which should be included in the reply to Mr. Jones are as follows:

a. While lifo may be called an inventory valuation method, primarily it is conceived of as a method of costing, or of charging out the cost of goods used or sold against operations. It means that the costs of the last goods received will be the first costs to be charged against operations, leaving the older costs as the inventory valuation on the balance sheet.

b. It is not correct to conclude that the lifo method will result in a tax saving—except in a specific year. When prices are rising, the use of this method in a given year or years will give a higher cost of goods sold and therefore a smaller net income, and hence a smaller income tax. Ultimately, however, when there is a period of declining prices, the opposite result will be attained, and the more recent costs charged to operations will be lower, resulting in a larger profit and increased taxes. Assuming no change in the tax rates, the total tax paid over the complete business cycle will be roughly the same as if any other method of inventory pricing technique had been used. It is true that if tax rates are higher during periods of rising price levels, and then these rates fall during the following period of declining price levels, there will be a tax saving.

c. Advantages claimed for the lifo method include: (a) It results in a better matching of costs and revenue because, when prices are moving either upwards or downwards, the method will result in charging to "cost of goods sold" costs more nearly in line with the price level at which sales of the goods are made. (b) Over the term of the business cycle it tends to show a smaller profit during the inflationary period and a larger profit during the deflationary period than would result from any other inventory pricing method. This might tend to help in "smoothing out" the peaks and troughs of the business cycle, thus in some measure promoting economic stability.

d. Disadvantages might include: (a) It results in an inventory figure for the balance sheet typical of price levels at a much earlier date, which may have little relation to present prices, thus reducing the significance of the balance sheet. (b) Although it may secure a better matching of costs and revenues in so far as sales and cost of goods sold are concerned, this is only a piecemeal attack on the effect of changing price levels. If this problem is to be dealt with, all phases of it should be considered, and both financial statements completely adjusted to a comparable price level basis through index number technique or some other method which treats of all items. (c) It will not achieve the desired result in the income statement if the goods sold during the period are in excess of the acquisitions of that period, necessitating the charging to cost of goods sold some of the opening inventory which is stated in terms of a quite different price level than presently exists (there is, however, a technique for handling this latter objection, although it raises some additional questions of interpretation). (d) It does not meet the stated objective of matching costs and revenue in those instances where changes in price levels are not reflected promptly in both the selling price and in the purchase price—in other words, where there is significant lag between the time of the rise or fall of prices secured through sales as compared with time of the rise or fall of prices paid for the goods to be sold.

There are several variations in practice in applying lifo. Special methods of application have been developed for department stores. In its application the lifo method is not a single method, but rather a variety of methods.

Solution 3

a. The presentation of the data is not generally acceptable. Two items, "Provision for future declines . . ." and "Elimination of reserve . . .," which should be presented in the statement of retained earnings have been included improperly in the determination of net income. The former item is an appropriation of retained earnings, not an income charge. The second item is a transfer from appropriated to unappropriated retained earnings. There is general agreement among accountants concerning the appropriate treatment of these two items, even among those who do not agree as to the treatment to be accorded the remaining two items shown in the income statement.

It is concerning so-called "extraordinary" or "unusual" items of profit-and-loss—which, although not related directly to the period's regular operations, were accorded recognition during the period—that a major difference of opinion has arisen among accountants.

Advocates of the "all-inclusive income statement" concept (often referred to as the "clean-surplus theory") argue that all items of a profit-and-loss nature *recognized during the period* must be included in the determination of net income for the period. (This is the position taken in the American Accounting Association statements on principles. This states that "no income, expense or loss may be credited or charged direct to earned surplus or to a contingency reserve.") Under this concept, the "loss on sale of land and buildings" and the assessment for prior year's taxes are treated properly in the question; and the retained earnings statement, after correction of the net income and inclusion of the two "surplus reserve" items, would be acceptable.

Advocates of the "current operating performance income statement," on the other hand, would require that all of the "special items" in the question's income statement be excluded from determination of net income. (Such exclusion is in accord with the position taken by the American Institute of Accountants' Committee on Accounting Procedure, which indicated in addition a strong preference for showing clearly the items under dispute in the statement of retained earnings.) The exclusion of the two "unusual" items of profit and loss from determination of net income under this concept is *not* on the grounds that *in principle* these types of items are not components of net income considered over a period of years. Rather, it is felt that exclusion of such items, when they are so material in amount in relation to net income that their inclusion would impair the significance of that figure, is necessary to prevent misinterpretation.

The Institute committee stated that "there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption relates to items which in the aggregate are material in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period." (Restatement and Revision of Accounting Research Bulletins, AIA, p. 63.) The Committee goes on to specify certain types of items which, if sufficiently material, should be excluded. The two profit and loss items in this question fall within those categories.

The Securities and Exchange Commission (revised Regulation S-X, item 17 of Rule 5-03) requires that in statements filed with the Commission any items of profit and loss given recognition in the accounts during the year but excluded from determination of net income be added to or deducted from the reported net income at the bottom of the income statement. The Institute's committee stated that in its opinion such treatment is acceptable provided that the figure reported as "net income" be clearly labelled so as not to be confused with the figure shown after such special items.

b. The principal arguments offered for the "all-inclusive" concept of income determination are as follows:

1. Statements over the life of the business should represent total income.
2. Manipulation is possible if items are to be allowed to by-pass the income account.
3. Statements will be easier to prepare and are subject to less variation resulting from different judgments as to items.
4. Users of statements can make their own adjustments more effectively than can management.
5. Annual figures have little significance for making decisions. Statements covering several periods should be used.

The principal arguments offered for the current operating performance concept are as follows:

1. Material extraordinary items may impair the significance of net income so that misleading inferences might be drawn therefrom.
2. An income figure should permit readers of statements to determine what a business was able to earn under the operating conditions of the period covered.
3. Management and independent accountants are in the best position to determine whether there are material extraordinary items which might mislead.
4. In spite of limitations, annual figures are commonly used in making investment decisions. The most useful figures must be provided for this purpose.

Solution 4

Items that might be included as elements of cost are:

a. Transportation
b. Insurance while in transit
c. Purchasing department costs
d. Receiving department costs
e. Storage costs
f. Interest or financing charges
g. Import duties

In general, all items of cost incurred relative to the inventories prior to their being put into production should be included as elements of inventory cost, in order that production (and ultimately revenue) should be charged with all costs incurred which relate to revenue—in other words, to secure proper matching of costs and revenue. If this were not done, these costs would be charged against revenue in the period when incurred, while the revenue resulting from the use of the materials might largely emerge in a succeeding accounting period, with resulting distortion of net income. One argument for excluding all of these items from inventory valuation is that to do so results in a "conservative" inventory. Conservatism, however, is no defense against improper matching of costs and revenue. Items which are not material in amount are frequently excluded because of the work involved in assigning them to specific items of inventory. This is a practical rather than a theoretical approach.

a. Transportation. This is one of the typical costs which should be included in inventory valuation. It is a normal cost of acquiring the material, and should be charged to the period in which the materials are used, hence must be included in the cost of any unused materials. If the transportation cost is relatively small, and the allocation of this cost over the several materials is clerically complicated, one might charge the cost to operations when incurred, without seriously disturbing the resulting net income.

b. Insurance while in transit. Here again we have a cost which business prudence requires in connection with shipments by water (and possibly in other cases), and the cost should be included in inventory valuation in order that it might be charged to operations in the period in which the materials are used.

c. Purchasing department costs. This item is usually charged to operations each period, rather than including it as an element of inventory valuation. This treatment is defended because of the extreme difficulty of arriving at any logical basis for allocating such costs to the several inventory items. Another argument against inclusion of purchasing department costs in inventory valuation is that these costs are relatively stable each accounting period—that is they do not fluctuate in relationship to the volume of materials acquired—and hence if allocated to inventories there might be rather extreme fluctuations in the "per unit" allocation from period to period. However, if some "normal" rate were utilized in this allocation procedure, it would appear that there is just as much justification for including these costs in inventory valuations as transportation, insurance and the like.

d. Receiving department costs. The arguments for and against inclusion of these costs in inventory valuation would be exactly the same as those relating to purchasing department costs.

e. Storage costs. Although the arguments for and against inclusion of storage costs may be much the same as those of purchasing and receiving costs, there are at least two additional arguments against their inclusion: (1) excessive storage costs resulting from unforeseen conditions should be treated as an expense of the period in which incurred, because it is the result of inefficiency and not a necessary cost of the production of revenue, and (2) under ideal conditions, there would be no storage costs because the materials would be purchased just as needed, hence eliminating storage costs. This latter argument is not particularly sound, however, because ideal conditions are seldom attained, and reasonable conditions should be the basis for such considerations.

f. Interest or financing charges. These costs are usually excluded, because the usual "cost" basis of valuation assumes sufficient funds available and that cost is the net cash outlay required. Interest or financing charges are the result of insufficient funds, and therefore should not enter into the determination of cost. Although the above line of reasoning is generally adopted, one might reason that a large proportion of business enterprises do not have sufficient funds for all purposes—that borrowing or other means of financing reflect usual business conditions—and hence these should be considered as cost elements in the same fashion as other normal business costs.

g. Import duties. The reasoning here is the same as presented in the case of transportation charges. There should be no difficulty in allocation to specific materials. Some might take the position that an import duty is a tax, and all taxes might properly be charged to expense in the period incurred, but this appears to be a dubious type of reasoning.

Solution 5

The proposal is evidently intended to reduce the "unit of property" for accounting purposes from a single unit to several smaller units. Such a breakdown rests on the theory that the various smaller units are dissimilar as to estimated life.

If the building is accounted for as a single unit, costs of repainting, replacement of heating plant, re-roofing, etc., will be charged as maintenance items. Depreciation will be computed on the building as a whole on the assumption that such maintenance will be undertaken as needed. However, because of the size of certain of these expenditures, the annual charges arising from the building will be irregular in amount.

If the building is accounted for as consisting of a number of units, the life of each of them would be estimated and depreciation taken accordingly. In this case, such expenditures as those for painting, re-roofing, re-wiring, etc., would involve a retirement of the original unit's cost and the capitalization of the cost of the new one. The aggregate annual depreciation charge would be higher than under the single unit plan, but maintenance charges would be lower. The total cost per year would tend to be more uniform from year to year.

Since it is impractical to break down property into as many separate units as are replaced, there would be a considerable amount of maintenance cost under either method. For instance, replacing a broken window would be maintenance in either case, as would repairing the roof, or cleaning the furnace.

The use of smaller units increases the work of setting up depreciation, but the computation might be more accurate as a measure of expiration of cost, especially during the early years of life. Also the use of smaller units may create some problems when replacements are made. Sometimes replacements are much more costly than the original installation because of physical difficulties, but may not be greater than the usefulness or value of the original installation.

As a general matter, accounting for a fixed asset in small units instead of as a single unit will increase annual depreciation, reduce annual maintenance, and increase the amount and frequency of retirements. Some businesses have arrived at about the same result by charging major maintenance items against the accumulated depreciation, but there are several objections to such a procedure.

Solution 6

The use of a natural business year benefits the client, the accountant, and the employees (or staff) of both of them.

The possible benefits of using the natural business year include the following:

a. The income statement will show results of operations during an actual cycle of business—rather than a mixture of the end of one season and beginning of another. If the statements cover a twelve-month period constituting a cycle rather than the twelve months in a calendar year which encompass parts of two successive business seasons (for example, the yearly automobile production cycle should encompass all the costs and sales of a distinct model), the statements are more significant.

b. The balance sheet will reflect a more liquid position with lower inventory and lower liabilities. Seasonal bank loans will have been liquidated, and there will be a more liquid condition. The report will be rendered when the client is over the seasonal peak of activity and he has had a chance to consolidate his position and to liquidate abnormal inventories.

c. It is easier to prepare financial statements and the statements are likely to be less affected by errors of judgment in making valuations.

1. A time of minimum activity will usually make accruals and adjustments simpler.
2. A reduced inventory will tend to reduce errors in valuations and in counting. A reduced work-in-process inventory will reduce the total problem involved in estimating applied overhead, labor and materials-in-process—there will be less margin for error (less units and less total dollars).
3. The method of inventory valuation will become less significant because of the lower inventory.
4. In general, incomplete transactions will be at a minimum; such items as research and development costs can more readily be applied to seasonal product instead of being estimated at an arbitrary December 31 closing amount.
5. Smaller payroll reduces problem of payroll accrual.
6. Lower accounts receivable reduces the problem of computing estimated bad accounts and estimated collections.

d. A more liquid position tends to reduce possible disputes over the amounts of income tax to be paid since there will be fewer estimates involved.

e. Annual statements will be available at the time they are needed for planning for the new production cycle.

Solution 7

a. Expenses are considered to be costs that have expired in the course of production of revenue whereas "losses" are costs that have expired without compensation or return.

Losses, in general, should never be deferred but should be charged against either current income prior to the reported net income or, if the item is material in amount and not a recurrent hazard of the business, charged to retained earnings. Cost and expenses may be deferred as inventory or otherwise carried to subsequent periods.

b. While losses occurring prior to beginning operations are frequently deferred in one manner or another, this practice does not appear to be sound. There can be a loss of capital during the organization and construction period, and such a loss should be recognized as a deduction from capital accounts and not carried forward to future periods. However, there frequently may be some doubt as to whether an expenditure will ultimately be a loss since that may depend on future developments. Because of this uncertainty, there are seldom any losses recognized.

c. Deferred charges are the result of expenditures or accruals that cannot be assigned to tangible assets; that are expected to benefit future periods; that do not consist primarily of a legal right; and that should be charged to future operations. The general distinction between deferred charges and prepaid expenses seems to rest in part on a time basis, with deferred charges frequently being applicable to a longer period than prepaid expenses. However, primarily the distinction is made on the basis of whether all services have been received that have been paid for by the business. If a right exists to receive future benefit (for instance, continued insurance protection) the items are classed as prepaid expenses. If no such right exists (for instance, cost incurred for plant rearrangement) but future revenues are expected to arise as the result of the expenditure, it is a deferred charge. Deferred charges should be written off in a systematic manner over the period during which the expenditure helped to create revenue. Since the revenue producing potential of many deferred charges is uncertain, conservatism dictates a relatively rapid write-off of many deferred items.

Solution 8

a. Marketable securities may be valued at market value where it is below cost. The market value in this instance is of significance to statement readers as an indication of the amount to be realized when the securities are sold. Market value may be disclosed parenthetically where above cost or it may be incorporated in the accounts by valuing the securities at the lower of cost or market. The justification for the use of market rests on the fact that these assets are classified as current.

b. For internal cost accounting purposes, a manufacturer may use appraisal value of assets. Depreciation for internal cost accounting purposes may be calculated on appraisal value of plant and equipment. The use of historical cost may not give management the most useful information especially when there has been a marked change in the price level. Where there are identical machines which have been purchased at different times and different prices, the cost accounting statements may be more useful by using appraisal value as a common denominator for depreciation. For purposes of setting prices in some circumstances or deciding on various possible alternatives a manufacturer may use market value of inventory since he is consuming materials which have a value different than cost.

c. In valuing mining property, discovery value has been applied as basis under tax rules. Discovery value is defined as the fair market value of the property at the time of or within thirty days of the discovery of the exploitable resources. This recognizes that the cost of the property before discovery of the resources gives no basis for a depletion charge. For significant reporting, some of the proceeds of the mine must be recognized to be a return of capital. All the proceeds do not represent profits. Percentage depletion, while not strictly a valuation basis, effectively serves as such a basis for tax accounting. It provides for using a percentage of receipts as an amount to be "expensed."

d. In deciding on a price to use in purchasing a business, attention is given to earning value. The value of a going business is measured by the value of the services or goods produced by a business. If a business uses more goods and services than it produces it has little economic value in the usual sense. If it produces more goods and services than it uses it has a positive economic value. In the first instance the business is operating at a loss, in the second at a profit. The selling price of a going business, in the last analysis, is determined by expectation of future earnings. In determining the price of a going business several methods of arriving at the price are frequently used. Capitalization of the excess earnings above an estimated reasonable return on the net tangible assets is the most common approach.

Solution 9

a. In view of the fact that the project has its own management and office staff, the inclusion of an additional 5% for the home office overhead of the venturers appears to be unjustified and not a proper cost of the project.

It is usually provided that additional services performed by employees or executives of the individual venturers' organizations should be charged separately as a project expense. The use of the staff of the managing venturer as to the management is compensated for in the 10% allowance before division of the profits in the agreed ratios (usually capital).

Another point to be considered is that the profits of the project are subject to renegotiation under the Renegotiation Act of 1951.

It seems probable that the arrangement is an attempt to load the job cost to escape or minimize the results of renegotiation.

b. The 5% amount in question is income only as a part of the profit (or loss) of the project; is not a separate profit item and should not be taken up separately. The profit of the project would be taken up by the venturers on whatever basis of accounting was elected—that is "percentage of completion" or "completed contract," etc.

A general question arises as to whether the renegotiation authorities would recognize the 5% charge as a proper project expense or cost. If such a charge was so recognized, then are not the individual venturers in the position of being subcontractors?

Answers to Examinations, May, 1956

Accounting Practice—Part I

May 9, 1956; 1:30 to 6 p.m.

Solution 1

A tax form was provided for the candidate, but because of space limitations the form is not reproduced. Pages and lines refer to the Standard Form 1040.

FORM 1040—1955

PAGE 1

Line 1:	Regular $600 exemption	Husband X	Wife X	
	65 or over at end of taxable year		Wife X	3
Line 2:	Name of children: Howard Scott		Child X	1
Line 3:	Dependents listed on page 2		X	1
Line 4:	Total number of exemptions on lines 1, 2 and 3			5

Line 5:		*Wages, etc.*	*Income Tax Withheld*
	Johnson Mfg. Co., Pittsburgh, Pa.	$27,750	$ 7,000
	Elaborate Foundry Co., St. Louis, Mo.	7,200	1,800
	Excess F.I.C.A.		84
	Totals	$34,950	8,884
Line 6:	Excludable "sick pay"	300	
Line 7:	Balance	$34,650	
Line 8:	Profit from business	3,000	
Line 9:	Profit from farming	—	
Line 10:	Other income from page 3	11,373	
Line 11:	Adjusted gross income	$49,023	
Line 12:	Tax (from line 9, page 2)		14,736.50
Line 13(a):	Dividend received credit	116	
Line 13(b):	Retirement income credit	120	236
Line 14:	Balance		14,500.50
Line 15:	Self-employment tax		—
Line 16:	Sum of 14 and 15		14,500.50
Line 17(a):	Tax withheld	8,884	
Line 17(b):	Payments	5,000	13,884
Line 18:	Balance (due)		$ 616.50
Line 19:	Overpayment		—

PAGE 2

Exemptions

R. R. Smith	None	Yes	No	All	None

Itemized Deductions

Contributions	$1,850
Interest	1,200
Taxes	2,000
Losses	200
Total	$5,250

Tax Computation

Line 1: Adjusted gross income	$49,023.00
Line 2: Deductions	5,250.00
Line 3: Balance	$43,773.00
Line 4: Exemptions (5 x $600)	3,000.00
Line 5: Taxable income	$40,773.00
Line 6: Tax	14,952.88
Line 7: Alternative tax	14,786.50
Line 8: Tax credits	
(a) Foreign tax	50.00
Line 9:	$14,736.50

PAGE 3

Schedule A—Income from Dividends

Line 1: Dividends from qualifying corporations	$3,000	
Line 2: Total	3,000	
Line 3: Exclusions (2 x $50)	100	
Line 4: Excess	$2,900	
Line 6: Total		$2,900

Schedule B—Income from Interest

AB Corp.	$ 400	
CD Corp.	180	
Penna. R. R.	270	850

Schedule D—Summary

Line 1: From capital assets	6,447
Line 2: From property other than capital assets	(150)

Schedule G—Income from Rents and Royalties

Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	
Store building, Pittsburgh, Pa.	$1,250	$214	$150	$200	
Line 1: Totals	$1,250	$214	$150	$200	
Line 2: Net profit					$ 686

Schedule H—Other Income

Line 3: Gambling gain	115	
Speech honorarium	25	
Foreign investment	500	640
Total income		$11,373

Schedule I—Depreciation in Schedule G

Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7
Brick store building (sold 3/1/55)	3/1/15	$60,000	$49,500	straight line	48 years	$214 (2/12 of 1 year)

PAGE 4

Schedule J—Dividends Received Credit

Line 1: Amount of dividends	$ 2,900.00
Line 2: Tentative credit (4% of line 1)	116.00
Line 3: Tax	$14,736.50
Line 4: 4% of taxable income	1,630.92
Line 5: Dividends received credit	$ 116.00

Schedule K—Retirement Income Credit

	Col. A (Wife)	Col. B (Husband)
Earned income in excess of $600	Yes	Yes
Line 1(a): For taxpayers under 65	—	(Nil)
Line (b): For taxpayers over 65	$1,450.00	—
Line 2: Maximum amount	1,200.00	$ 1,200.00
Line 3: Deduct:		
(a) Social security receipts	600.00	—
Line 4: Total	600.00	—
Line 5: Balance	$ 600.00	—
Line 6: Smaller of 1 or 5	600.00	—
Line 7: Tentative credit (20%)	120.00	—
Line 8: Total tentative credit		$ 120.00
Line 9: Amount of tax		$14,736.50
Line 10: Dividends received credit		116.00
Line 11: Balance		14,620.50
Line 12: Retirement income credit		120.00

SCHEDULE D 1955

Name and address: John C. and Mabel Scott, 145 Oakview Lane, Pittsburgh, Pa.

Capital Assets

Short-Term Capital Gains and Losses

Col. a	Col. b	Col. c	Col. d	Col. e	Col. f	Col. g	Col. h
Line 1:							
ZZ Common	7/ 2/55	12/31/55	—	—	500	—	(500)
Personal loan (worthless)	12/ 8/54	12/31/55	—	—	1,000	—	(1,000)
Line 4: Net short-term capital loss							(1,500)

Long-Term Capital Gains and Losses

Line 5:

Col. a	Col. b	Col. c	Col. d	Col. e	Col. f	Col. g	Col. h
Residence*	1/ 5/45	2/20/55	28,000	—	27,000	—	1,000
Land	3/ 1/15	3/ 1/55	18,000	—	15,000	—	3,000
Store Bldg.	3/ 1/15	3/ 1/55	13,560	49,714	60,000	—	3,274
FF Common	2/ 5/51	6/11/55	10,000	—	4,000	90	5,910
HH Preferred	3/ 1/54	12/ 1/55	5,000	—	4,000	50	950
GG Common	10/11/51	8/31/55	1,100	—	800	40	260
Line 7: Net long-term capital gain							14,394

**Sale of personal residence*

2/20/55 Sale of former residence		$28,000
1/ 5/45 Cost of former residence		25,000
		$ 3,000
Taxable gain		
Sale of former residence		$28,000
4/1/55 Cost of new residence	$24,000	
May 1955 Cost of addition to new residence	3,000	27,000
Excess of sale price of former residence over cost of new		$ 1,000

Gain or Loss to Be Taken into Account

Line 8: Short-term loss		1,500
Line 9: Long-term gain	14,394	
Line 11: Long-term gain reduced by short-term loss	12,894	
Line 12: 50% of line 11	6,447	
Line 13: Sum of 10 and 12	6,447	

Computation of Alternative Tax

Line 16: Taxable income	40,773.00
Line 17: From line 12	6,447.00
Line 18: Balance	34,326.00
Line 19: Tax on amount on line 18	11,563.00
Line 20: 50% of line 17	3,223.50
Line 21: Alternative tax	14,786.50

Property Other Than Capital Assets

Line 1: Testing equipment	5/15/55	10/15/55	300	50	500	—	(150)
Line 3: Net loss							(150)

Solution 2

a. RECONCILIATION OF INTERCOMPANY ACCOUNTS

Apex Company

Balance per books December 31, 1955		$28,189
Add December sale on invoice No. 17881 not recorded		3,647
		$31,836
Deduct:		
Cash receipt in transit	$19,777	
Returned goods not recorded	2,329	22,106
Adjusted balance per books December 31, 1955		$ 9,730

Apex Sales Co.

Balance per books December 31, 1955		$ 6,318
Add purchases not recorded:		
Invoice No. 17879 Receiving report No. 34337	$ 2,183	
Invoice No. 17880	849	
Invoice No. 17882	1,891	4,923
		$11,241
Deduct: January 1956 purchase, invoice No. 17883, recorded in December 1955		1,511
Adjusted balance per books December 31, 1955		$9,730

b. (1) **ENTRIES TO ADJUST THE BOOKS AT DECEMBER 31, 1955**

On the Books of Apex Company

Intercompany account—Apex Sales Co.	$ 3,647	
Sales		$ 3,647
To record December 1955 sale not recorded—invoice No. 17881		
Cash	19,777	
Intercompany account—Apex Sales Co.		19,777
To record cash in transit at December 31, 1955		
Sales returns	$ 2,329	
Intercompany account—Apex Sales		$ 2,329
To record returned merchandise in transit at December 31, 1955		

On the Books of Apex Sales Co.

Cost of sales—purchase	4,923	
Intercompany account—Apex Company		4,923
To record December purchases not recorded		
Intercompany account—Apex Company	1,511	
Cost of sales—purchases		1,511
To reverse entry recording January 1956 purchase in December 1955, invoice No. 17883		

b.(2) **INVENTORY ADJUSTMENTS**

On the Books of Apex Company

Inventory	1,941	
Cost of sales—ending inventory		1,941

To record inventory value of returned merchandise in transit at December 31, 1955

$$\frac{100}{120} \times \$2,329 = \$1,941$$

On the Books of Apex Sales Co.

Inventory	2,740	
Cost of sales—ending inventory		2,740

To record inventory in transit at December 31, 1955:

Invoice No. 17880	$ 849
Invoice No. 17882	1,891
	$2,740

Solution 3

a. **STANDARD COST SHEET**

Lano-Lov Skin Lotion		Unit: 1 gross bottles, packaged
Date: 5/9/56	Approved: LMS	Unit cost: $16.08

1. Container

Unit	Description	Purchase Cost: Price	Purchase Cost: Quantity	Loss allowance	Standard unit cost
2147	4 oz. bottle	$5.50	Gr	2% added	$5.61
315	Label	3.30	M	3% added	.49
					$6.10

2. Raw Materials

Unit	Description	Purchase Cost: Price	Purchase Cost: Quantity	Std.—125 gals.: Quantity	Std.—125 gals.: Cost	
4247	Compound 34A	$40.00	cwt.	70.0#	$ 28.00	
3126	Alcohol and glycerin	40.00	cwt.	76.0#	30.40	
4136B	Perfume oil	24.40	lb.*	3.5#	85.40	
	125 gallons @ $1.15				$143.80	
	1 gross: 4.5 gal. @ $1.15					5.18

*perfume oil (90 lb. batch)

Ingredients		$2,169.95	
Direct labor — 4.4 hrs. @ $2.28		10.03	
Overhead		7.50	
	4.4 hrs. @ $1.95	8.58	
		$2,196.06	= $24.40 lb.

3. Allowance for Lost Material
4% of $5.18 .21

4. Direct Labor

Department	Standard time	Standard rate	Extended	
Compounding	.12 hr.	1.90	$0.23	
Filling and packaging	1.00 hr.	1.60	1.60	1.83

5. Manufacturing Overhead

Department	Standard time	Standard rate	Extended	
Compounding	.12 hr.	3.00	$0.36	
Filling and packaging	1.00 hr.	1.50	1.50	
Per gross		0.90	0.90	2.76
Total standard cost				$16.08

b. **ANALYSIS OF DIRECT LABOR VARIANCE**

Filling and Packing

	Hours		*Rate*	*Amount*
Actual for 800 gross	780		$1.62	$1,263.60
Standard for 800 gross	800		1.60	1,280.00
Difference	— 20		+$ .02	—$ 16.40
Variance due to saving hours	— 20	@	$1.60	—$ 32.00
Variance due to higher rate	780	@	+ .02	+ 15.60
Net Variance				$ 16.40

Solution 4

CITY OF M WATER DEPARTMENT

a. **Balance Sheet December 31, 1955**

Assets	
Cash	$ 717
Accounts receivable	5,573
Stores	12,635
Investments of replacement fund	26,100
Permanent property	226,664
Total	$271,689
Liabilities	
Accounts payable	$ 5,918
Customers' deposits	1,660
Bonds payable	40,000
Surplus:	
Operating surplus	45,407
Replacement fund reserve	26,100
Capital surplus	152,604
Total	$271,689

b. **Operating Statement—For the Year Ending December 31, 1955**

Operating income:		
Services to customers		$146,867
Less operating expenses:		
Payrolls and other expense	$69,826	
Stores used	32,615	
Supplies expense	7,197	
Depreciation on property	10,600	120,238
Net operating income		$ 26,629
Other income:		
Income on investment		1,102
Total income		$ 27,731
Other expense:		
Interest on bonds		3,000
Net income to surplus		$ 24,731

c. **Statement of Operating Surplus**
For the Year Ending December 31, 1955

Balance at beginning of year	$ 21,773
Add: Net income for the year	24,731
	$ 46,504
Deduct: Bad debts of prior years written off	1,097
Balance at end of year	$ 45,407

Solution 5

PARCO, INC. AND SUBSIDIARY

Consolidated Worksheet as of December 31, 1955

	Per Books			
	Parco	*Subco*	*Eliminations*	*Consolidated*
Cash	$ 490,327	$ 31,187		$ 521,514
Accounts receivable	940,227	203,287		1,143,514
Inventories	1,952,173	535,711		2,487,884
Investment in Subco—cost	550,000	—	(1) ($458,984)	—
			(2) (91,016)	—
Amortization of investment (Schedule 1)	(22,754)	—	(1) 22,754	—
Reserve for loss of Subco (Schedule 2)	(67,602)	—	(3) 67,602	—
Advances to Subco	180,000	—	(4) (180,000)	—
Prepaid expenses	34,327	4,621		38,948
Excess of cost of stock of subsidiary over net book value of assets acquired (less amortization of $22,754)			(2) 91,016	91,016
	$4,056,698	$774,806		$4,282,876
Accounts payable	$ 298,627	$226,178		$ 524,805
Federal income taxes payable	443,500	—		443,500
Advances from Parco	—	180,000	(4) 180,000	—
4% Debentures due 12/31/63	550,000	—		550,000
Capital stock—Parco	300,000	—		300,000
Capital stock—Subco	—	50,000	(1) 50,000	—
Retained earnings—Parco (Schedule 3)	2,464,571			2,464,571
Retained earnings—Subco (Schedule 4)	—	318,628	(1) 386,230	—
			(3) (67,602)	
	$4,056,698	$774,806		$4,282,876

ELIMINATIONS

(1) To eliminate the stock and earnings against the amortized cost of investment.
(2) To separate the unamortized excess of cost of investment over book value. (This might be charged against Retained earnings because the continued losses do not justify treatment as goodwill.)
(3) To offset loss of Subco against reserve on Parco books.
(4) To eliminate intercompany advance.

SCHEDULE 1

Face value of debentures		$ 550,000
Net value of assets acquired:		
Capital stock	$ 50,000	
Retained earnings	386,230	436,230
Excess of cost over assets acquired		$ 113,770
Amortization per year		$ 11,377
Amortization for two years		$ 22,754

SCHEDULE 2

Loss of Subco—1954	$ 52,376
Loss of Subco—1955	15,226
Loss since acquisition	$ 67,602

SCHEDULE 3

Retained earnings 12/31/53		$2,047,453
Net income:		
1954—before adjustment	$387,465	
1955—before adjustment	420,009	
Total—before adjustment	$807,474	
Amortization (Schedule 1)	$ 22,754	
Loss of Subco (Schedule 2)	67,602	
Total	$ 90,356	
Net income		717,118
Dividends paid ($150,000 per year)		(300,000)
Retained earnings 12/31/55		$2,464,571

SCHEDULE 4

Retained earnings 12/3/53	$ 386,230
Losses for 1954 and 1955	67,602
Retained earnings 12/31/55	$ 318,628

Accounting Practice—Part II

May 10, 1956; 1:30 to 6 p.m.

Solution 1

a. Computation of Federal Income Tax Liability for 1955

Net income per books		$219,500
Tax adjustments:		
Add back insurance on officers' lives	$ 4,800	
Add back charitable contributions	10,000	14,800
		$234,300
Excess of depreciation and amortization for tax purposes over depreciation per books (see Schedule 1)		52,000
		$182,300
Property used in trade or business (Land and Punch Press):		
Eliminate net gain per books		500
		$181,800
Punch Press—loss	$4,500	
Land—gain recognized ($20,000 — $19,000)	1,000	3,500
		$178,300
Capital assets:		
Gain on sale of corporate stock, $6,000—eliminated by capital loss carry-over of $6,500 from 1953		6,000
Taxable income before contributions		$172,300
Contributions—5%		8,615
		$163,685
Special deduction—85% of dividends received		8,500
Taxable income		$155,185
Tax:		
52% of $155,185		$ 80,696
Less		5,500
Tax liability for 1955		$ 75,196

SCHEDULE 1

Depreciation and Amortization

	Cost	Regular Rate	Per Books	Per Tax Return
Regular property			$32,200	$ 32,200
Property constructed under certificate of necessity (80%):				
Building:	$100,000	5%		
Depreciation on 20% of cost			1,000	1,000
Depreciation and amortization on 80% of cost			4,000	16,000
Machinery:	500,000	10%		
Depreciation on 20% of cost			10,000	10,000
Depreciation and amortization on 80% of cost			40,000	80,000
Total			$87,200	$139,200
				87,200
Excess of depreciation and amortization for tax purposes over depreciation per books				$ 52,000

b. Journal Entry (amounts would usually be rounded)

Provision for federal income tax	$101,516	
Accrued federal income tax		$75,196
Deferred federal income tax		26,320

To provide for 1955 federal income taxes and to defer the reduction in taxes attributable to amortization not recorded on the books

COMPUTATIONS

Difference in tax due to amortization of emergency facilities

Taxable income before contributions, as above		$172,300
Excess of depreciation and amortization for tax purposes over depreciation per books		52,000
Contributions	$(10,000)	
Dividends received credit	(8,500)	(18,500)
Taxable income		$205,800
Tax: 52% of $205,800	$107,016	
Less	5,500	$101,516
Tax per return		75,196
Difference		$ 26,320

Note: An alternative is to consider the difference in tax as 52 per cent of $52,000 or $27,040 and to ignore the special feature of the contribution deduction, especially in view of the contribution carry-over provisions.

c. **Footnote**

It may be assumed that the amounts involved are material—in relation to sales of $850,000 and net income of $219,500. Accordingly, a footnote might be included with the financial statements substantially as follows:

Depreciation and Amortization

Certified portions of assets acquired under certificates of necessity are amortized for federal income tax purposes over sixty-month periods; depreciation for financial statement purposes is based upon the estimated economic lives of the assets. The excess of the special amortization over regular depreciation was $52,000 for 1955, and the accumulated excess at December 31, 1955 was $156,000. The approximate tax effect of this excess, which has been charged to income and included in deferred income taxes in the accompanying balance sheet, was $26,000 for 1955 and a total of $78,000 at December 31, 1955. In years following the amortization period when depreciation recorded in the accounts will exceed that deductible for tax purposes, this amount will be restored to income.

Solution 2

THE BIGBEE COMPANY

Estimated Sales and Costs of Sales for Period 3

	Amount	*Per Unit*
Sales	$475,000	$19.00
Direct materials used (see Schedule 2)	$ 58,800	$ 2.40
Direct labor (see Schedule 3)	113,190	4.62
Factory overhead (see Schedule 4)	54,088	2.21
Inventory variation (see Schedule 5)	2,185	
	$228,263	
Gross profit	$246,737	

SCHEDULE 1

Computation of Production

Units to be sold	25,000
Ending inventory (10% as in periods 1 and 2)	2,500
Total	27,500
Opening inventory	3,000
Units to be produced	24,500

SCHEDULE 2

Computation of Raw Material Cost

	Period 1		Period 2		
Material	*Amount*	*Per Unit*	*Amount*	*Per Unit*	*Increase*
A	$23,141	1.10	$37,542	$1.21	10%
B	20,937	1.00	30,966	1.00	0
Total	$44,078	$2.10	$68,508	$2.21	

Computation of Cost per Unit

Material	*Per Unit Period 2*	*Increase in Cost Per Unit* %	*Increase in Cost Per Unit* *Amount*	*Total Unit Cost*	*Change in Quantity*	*Cost*
A	$1.21	10%	$.12	$1.33	— 8%	$1.22
B	1.00	5%	.05	1.05	+12%	1.18
	$2.21			$2.38		$2.40

Material for production of 24,5000 units @ $2.40 equals $58,800

SCHEDULE 3

Direct Labor Cost

Labor cost per unit of product in period 2	$ 4.20
Increase of 10%	.42
Cost per unit in period 3	$ 4.62
Cost of 24,500 units	$113,190

SCHEDULE 4

Factory Overhead

Segregation into Fixed and Variable Elements

Total factory overhead	$62,213
Fixed overhead	23,463
Variable overhead	$38,750
Units produced	31,000
Variable overhead per unit	$1.25

Overhead in Period 3

	Amount	*Per Unit*
Fixed element	$23,463	
Variable element (24,500 units × $1.25)	30,625	
	$54,088	$2.21

SCHEDULE 5

Inventory Variation

	Period 2	*Period 3*
Units in ending inventory	3,000	2,500
Cost per unit	$8.42	$9.23
Cost of ending inventory	$25,260	$23,075
Net decrease		$2,185

Solution 3

X CORPORATION

Adjusting Journal Entries (not required)

The following journal entries are numbered to correspond with the numbers in the worksheet but there is a more detailed breakdown.

(1)

Materials purchased	$ 1,000	
Cash		$ 1,000
To record expenditures made out of petty cash		

(1)

Cash	40,000	
Accounts payable		40,000
To reverse the effect of checks drawn after the close of the year but included in the December cash book		

(2)

Amounts due from officers	40,000	
Accounts receivable—other	10,000	
Accounts receivable—trade		50,000
To reclassify non-trade receivables		

(2)

Miscellaneous administrative and general expenses	200	
Accounts receivable—trade		200
To conform control account to identifiable details		

(3)

Bad debts	25,000	
Reserve for doubtful accounts		25,000
To provide for doubtful accounts		

(4)

Decrease in inventories	57,000	
Inventories		57,000
To adjust for errors in recording the physical inventory, as follows:		
Overstatement:		
Factory supplies inventories	$ 5,000	
Consigned material inventories	35,000	
Items inventoried twice	26,000	
Extension and footing errors	10,000	
		$76,000
Understatement:		
Material in transit	$15,000	
Inventory items omitted in error	4,000	19,000
Net overstatement		57,000

(4)

Inventories	$ 8,000	
Decrease in inventory		$ 8,000

To record work-in-process inventory at the market value, which is lower than cost including overhead (50% of $416,000 equals $208,000 market. Cost equals $200,000 plus 10%)

(4)

Inventories	20,000	
Decrease in inventory		20,000

To record the value of overhead in both finished goods and work in process inventory of $10,000 each

(5)

Investments (U.S. Treasury Bonds)	3,000	
Miscellaneous administrative and general expenses		3,000

To correct entry for bond premium

(5)

Amortization of bond premium	300	
Investments (U.S. Treasury Bonds)		300

To record 1955 amortization of bond premium

(5)

Treasury stock	5,000	
Investments		5,000

To set up treasury stock in separate account

(6)

Deposit on machinery	5,950	
Advertising expense	2,000	
Prepaid advertising	4,000	
Deferred charges		11,950

To reclassify deposit and to record 1955 advertising expense

(7)

Accrued liabilities	90,000	
Federal taxes		90,000

To reverse the tax accrual set up on the books

(8)

Mortgage payable	10,000	
Mortgage payable—installment currently due		10,000

To segregate the installment due in the current year from the long-term liability

(9 & 10)

Organization expense	3,000	
Earned surplus	7,000	
Capital surplus		10,000

To correct erroneous entries in the earned surplus account

(11)

Miscellaneous income	$ 300	
Dividends paid		$ 300

To eliminate duplication of income caused by recording the dividends paid on treasury stock

(12)

Deferred charges—prepaid rent	10,000	
Rent		10,000
To defer payment of January, 1956 rent		

(13)

Unexpired insurance	10,000	
Insurance expense		10,000
To record unexpired insurance		

(14)

Service guaranty costs	12,000	
Reserve for service guaranty		12,000

To set up reserve for estimated costs necessary to fulfill the guaranty in connection with 1955 net sales

(15)

Repairs	8,000	
Accounts payable		8,000
To set up unrecorded invoice		

(16)

Provision for federal income taxes	67,200	
Accrued federal income taxes—current year		67,200

To adjust the current year's tax provision in accordance with revised taxable income of $139,800, consisting of book income of $127,800 plus $12,000 of provision for service guaranty cost which is not deductible for tax purposes

a.

X CORPORATION

Worksheet of Balance-Sheet Accounts, December 31, 1955

	Preliminary Trial Balance		*Adjustments*		*Adjusted Trial Balance*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash	25,000		(1) 40,000	(1) 1,000	64,000	
Accounts receivable —Trade	350,000			(2) 50,200	299,800	
Accounts receivable —Officers			(2) 40,000		40,000	
Accounts receivable —Miscellaneous			(2) 10,000		10,000	
Allowance for loss on accounts				(3) 25,000		25,000
Inventories	700,000			(4) 700,000		
Finished goods			(4) 110,000		110,000	
Work-in-process			(4) 110,000		110,000	
Contracts-in-process			(4) 208,000		208,000	
Raw materials			(4) 243,000		243,000	
Investments	80,000		(5) 2,700	(5) 5,000	77,700	
Machinery and Equipment	164,000				164,000	

	Preliminary Trial Balance		*Adjustments*		*Adjusted Trial Balance*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Reserve for depreciation—M. & E.		30,200				30,200
Office equipment	2,500				2,500	
Reserve for depreciation—Office equipment		650				650
Prepaid rent			(12) 10,000		10,000	
Prepaid insurance			(13) 10,000		10,000	
Deferred charges	11,950			(6) 11,950		
Deposit on machinery			(6) 5,950		5,950	
Prepaid advertising			(6) 4,000		4,000	
Organization expense			(9) 3,000		3,000	
Accounts payable		61,600		(1) 40,000		
				(15) 8,000		109,600
Mortgage payable—current portion				(8) 10,000		10,000
Accrued liabilities		95,000	(7) 90,000			5,000
Reserve for service guarantee				(14) 12,000		12,000
Accrued federal income taxes				(16) 67,200		67,200
Mortgage payable		90,000	(8) 10,000			80,000
Preferred stock		10,000				10,000
Common stock		1,000,000				1,000,000
Common stock in treasury			(5) 5,000		5,000	
Earned surplus—1/1/55		14,000	(10) 10,000	(9) 3,000		7,000
Capital surplus				(10) 10,000		10,000
Dividends paid	60,600			(11) 300	60,300	
Provision for federal taxes on income	90,000		(16) 67,200	(7) 90,000	67,200	
Current year's net income before federal income taxes		182,600	(1) 1,000	(5) 2,700		
			(2) 200	(12) 10,000		
			(3) 25,000	(13) 10,000		127,800
			(4) 29,000			
			(6) 2,000			
			(11) 300			
			(14) 12,000			
			(15) 8,000			
	1,484,050	1,484,050			1,494,450	1,494,450

b.

X CORPORATION

Balance Sheet, December 31, 1955

Assets

Current Assets:		
Cash		$ 64,000
Accounts receivable:		
Customers (less reserve for doubtful accounts, $25,000)	$274,800	
Due from officers	40,000	
Other	10,000	
Total		324,800
Inventories—at lower of cost or market:		
Finished goods	$110,000	
Work-in-process	110,000	
Raw materials	243,000	
Contracts-in-process	208,000	671,000
Prepaid expenses:		
Unexpired insurance	$ 10,000	
Prepaid rent	10,000	
Prepaid advertising	4,000	
Total		24,000
Total current assets		$1,083,800
Investments:		
United States Treasury Bonds (quoted market value, $72,900)—at cost, less amortization of bond premium, $300	$ 72,700	
Other	5,000	77,700
Property (at cost):		
Machinery and equipment	$164,000	
Office equipment	2,500	
Total	$166,500	
Less reserves for depreciation	30,850	135,650
Deposit on Purchase of Machinery		5,950
Organization Expense		3,000
		$1,306,100

Liabilities

Current Liabilities:			
Accounts payable			$ 109,600
Accrued federal income taxes			67,200
Other accrued liabilities			5,000
Reserve for service guaranty			12,000
Mortgage—installment due in 1956			10,000
Total current liabilities			$ 203,800
Mortgage-Notes (5% due serially to 7/1/64)			80,000
Capital Stock and Surplus (*see note*)			
Capital stock:			
Preferred, 6% cumulative, convertible, $10 par (authorized, 5,000 shares; issued and outstanding, 1,000 shares)		$ 10,000	
Common, $10 par (authorized and issued) 100,000 shares	$1,000,000		
Less held in treasury, 500 shares	5,000		
Outstanding—99,500 shares (*see note*)		995,000	
Surplus:			
Capital surplus	$ 10,000		
Retained earnings	7,300	17,300	
Total capital stock and surplus			1,022,300
			$1,306,100

Note: On February 16, 1956 an additional 50,000 shares of the company's common stock were authorized for issuance.

c. Qualifications in Certificate

(1) As to scope, mention would be made of non-observation of opening inventories.

(2) As to consistency, mention would be made of exclusion of overhead in opening inventories. If the company has not been setting up major prepayments, this change also should be covered.

(3) In view of the inconsistencies, and unless satisfactory tests can be made of the reasonableness of the opening inventories, no opinion should be expressed on the income statement.

Auditing

May 10, 1956; 9 a.m. to 12:30 p.m.

Solution 1

While some of the procedures that would be followed are the same for inventories in warehouses as for inventories on consignment, there are enough special features to justify separate answers.

Inventories in Warehouses:

(a) Send confirmation requests to all warehouses where there are material amounts of inventory. Follow up as necessary and reconcile replies with the book records.

(b) If large amounts are in a few warehouses care must be exercised to determine the validity of the confirmations and it may be desirable to test the quantities by physical counts.

(c) Since warehouses issue receipts which may be negotiable, examine the receipts held by the company for all major amounts.

(d) Make tests of records supporting the inventory of goods in warehouses. These tests will include:

  (1) Test of shipments to warehouses to supporting documents.
  (2) Test of purchases shipped direct by suppliers to warehouses.
  (3) Test of the sales and shipments from warehouse stocks.
  (4) Tests of the clerical accuracy of the records of balances in warehouses.

(e) The following additional procedures may be followed on a test basis:

  (1) Test the cut-offs of sales and purchases.
  (2) Examine the invoices for storage charges.
  (3) Investigate the possibility of the inventory being pledged for loans.

Inventories on Consignment:

(a) Confirm major amounts, if any, by correspondence. Follow up on requests.

(b) Prove some of the amounts against statements received from the consignee (account sales statements).

(c) Make tests to determine that the inventory is valued at cost plus appropriate charges for shipment and that no profit is included.

(d) Make tests of shipments to consignees against supporting documents. Test the year-end cut-offs of sales and shipments.

(e) The following additional procedures may be applied on a test basis:

  (1) Examine consignment agreements.
  (2) Test the clerical accuracy of the records.
  (3) Test shipping expense.
  (4) Review the policy as to including expenses in inventory.
  (5) Check for obsolete or slow-moving goods.

Routine Procedures:

The regular procedures which apply to any inventory would also apply here. Included would be such steps as review of internal control and obtaining an inventory certificate.

Solution 2

a. Procedures followed in ascertaining significant happenings subsequent to the date of the financial statements should be less extensive than those applied as of such date. However, generally the following steps are considered to be desirable:

(1) Read available minutes of meetings and check interim company statements.

(2) Scan, examine or test such items as bank statements, returned checks, accounts receivable collections, sales of inventory, returns and allowances, vouchers for liabilities, etc., of the subsequent period.

(3) Make inquiries of responsible officials as to any material happenings during the subsequent period and obtain written representations from the client as to subsequent happenings.

In addition to the foregoing the auditor should be on the lookout throughout his audit for subsequent events which may have to be dealt with in some manner. Any clues developed during the course of the audit work should be followed to a conclusion.

b. In general, the period of occurrence of post-balance-sheet events extends from the balance-sheet date to approximately the date of completion of all important audit procedures. This date should normally be used as the date of the auditor's report. In most cases this date will coincide with the completion of the work in the client's office. However, if the auditor learns of any significant events up to time of delivery of the report, he is responsible for dealing with those events.

c. Subsequent events or transactions can be classified in accordance with their treatment into three types. Examples of each are:

Type 1 (*Assume December 31 date*):

Settlement of a tax controversy in January that would have a bearing on the tax accruals as of the preceding December 31.

The bankruptcy in January of an important debtor whose account had been considered collectible.

Receivables of substantial amount subsequently found to be in dispute, which would have to be taken into account in considering the adequacy of the reserve for doubtful receivables as of the preceding December 31.

Type 2:

The sale of a large bond or capital stock issue with restrictive covenants.

Mergers.

Acquisitions.

The disposal of an important investment or other capital asset.

Collection of a substantial amount of insurance on the life of a deceased officer.
An important fire loss or similar casualty.

Type 3:
Major management changes.
Product changes.
Strikes.
Unionization.
Loss of important customers.

d. The primary responsibility for the financial statements, and accordingly for any adjustment or disclosure because of post-balance-sheet events, is that of the auditor's client. However, to the extent the auditor has knowledge of post-balance-sheet events or transactions which may be significant in relation to specific financial statements, it is his duty either:
   (1) To see that they are properly considered and when deemed appropriate, given effect by adjustment or annotation of the financial statements; or
   (2) If in his opinion, there is significant lack of compliance with (1) above, to qualify his report or to present therein appropriate information, depending upon the circumstances.

e. The "Type 1" events directly affect the financial statements and should be reflected therein by appropriate adjustments. The "Type 2" events have no direct effect on the financial statements of the period, but they will require accounting entries in the subsequent period. They are "unusual," and if they are significant, should be disclosed. The "Type 3" events are non-accounting events since they will not directly require recognition in the accounts for this or any future period. As a general rule they need not be disclosed in the statements.

Solution 3

a. *Steps and arrangements*:
   (1) Obtain a copy of the lease agreement and examine it, with particular emphasis on those provisions relating to the right to examine the books and records and to the royalty provisions.
   (2) Discuss with the legal counsel of the partners any provisions of the agreement needing clarification.
   (3) Obtain copies of the statements of the tons mined and sold as received by the partners, examine them and prove their arithmetical accuracy.
   (4) Examine the partners' cash receipts records, and prepare a list of the royalty checks received from Premur showing full information as to amounts and dates received and deposited.
   (5) Have the client make arrangements with the coal company for your examination, including the day you will begin work, a place to work and full access to the books and records of the company.
   (6) Have the client provide you with a letter of introduction and authorization to perform the examination.

b. *Audit procedures*:

(1) Review the Premur Company's internal control over preparation of production and shipping records, statements of tons mined and sold and royalty payments to the partners.

(2) Prove the client's copies of the statements of tons mined and sold to the production and shipping records of the company to ascertain that they are in agreement.

(3) Prove the list of royalty checks received by the client to the company's check register as to amounts, dates issued, dates cancelled, etc.

(4) Examine the production records of the company and reconcile them to the inventory records and the statements of tons mined and sold, to ascertain that all coal mined is in inventory or reported as sold.

(5) Trace issues from inventory into the sales records to ascertain that all sales as recorded are included in the statements of tons mined and sold.

(6) Examine the shipping records as to weights shipped and dates, proving them to the original bills of lading or freight manifest and the scale tickets of weights supplied by the railroad. Trace the shipments by numbers, weights, and dates into the statements of tons mined and sold, watching for any differences in weights, numbers and dates, or any break in sequence.

(7) Observe and make inquiries to determine whether any coal is being shipped by truck rather than rail and not being reported. Include tests of any available shipping documents and records of weights.

(8) Examine reports to the miners' union for assessments based on tonnage, seeing that they agree with the client's statements of tonnage mined and shipped.

(9) Review the payroll records and ascertain the average number of miners per shift, the number of shifts, and the average production per miner and shift. Compare these data to the production records for a test period to determine whether any tonnage mined is being omitted from the records.

(10) Review any available severance tax and income tax reports which might give evidence of the tonnage mined and shipped and royalties deducted.

(11) Review the accounts receivable and collections and reconcile them for a test period to the sales record to ascertain if any accounts are outstanding or if collections are being made on unreported sales.

(12) Review the cash receipts record for sales which do not go through accounts receivable.

(13) Make tests of the freight expense account to determine that shipments have been recorded as sales.

Solution 4

a.

Y COMPANY
Petty Cash Count
November 10, 1955

Currency (counted)		$2,200
Cashed checks		500
Vouchers		740
N.S.F. checks dated June 10 and 15, 1954		260
Total		$3,700
Deduct: Petty cash receipt vouchers:		
Return of expense advance	$200	
Sale of money orders (#C1015-1021)	100	300
Remainder		$3,400
Indicated shortage		1,600
Total fund, November 10, 1955		$5,000

b. In view of the indicated shortage of $1,600, all items should be thoroughly investigated. The following procedures might be used:

(1) Cashed checks—Examine checks as to payee, endorsement and date. Review checks with responsible official as to approval and procedure and request that checks be deposited under control of auditors with instructions to the bank officials to return any N.S.F. checks direct to the auditors.

(2) Vouchers—Examine vouchers as to date, signature of recipient, explanation, approval, and, where applicable, supporting documents, invoices, etc. and if not approved, request responsible official to approve them. Note any evidence of erasure of amount or date.

(3) N.S.F. checks—Obtain information as to why these old checks are still on hand. These checks should be shown as receivables and not as part of the petty cash fund. Obtain confirmation of these items by direct correspondence with the drawer.

(4) Returned advances—These are not a proper part of the petty cash fund and should be entered on the books as a reduction of the advance account. In view of the shortage, confirm by direct correspondence all advances as of November 10, 1955.

(5) Money orders—Examine latest report to Express Company showing latest sales. Confirm with Express Company all unreported money orders sold and all unissued money orders on hand as of November 10, 1955. Inasmuch as the Y Company does not pay for the money orders when received the inclusion of the six orders in the count was erroneous and the cashier's statement that $600 was paid for them was untrue. Receipts from the sales of money orders are not part of the petty cash fund. Such funds belong to the Express Company and the $100 should be deducted from the cash.

(6) Unclaimed wages—The unclaimed wage envelopes should be opened and the contents counted. The total amount of each envelope should be traced

to the payroll records, and the total of all such unclaimed wages on hand should be agreed with the control account for unclaimed wages.

(7) Vouchers subsequently produced—Examine carefully all vouchers produced after making original count, noting date, signature of recipient, approval and amount. Inasmuch as all of these vouchers represented wage advances, confirm all items directly with the employees. The evidence may establish that these vouchers were a proper part of the fund.

(8) Book balance—The possibility that the book balance is not correct should be considered. Inquiry should be made to determine that the fund has not been reduced, but the credit not posted to the ledger account.

The above audit procedures may uncover additional shortages requiring a complete investigation of the petty cash procedures. After completion of these audit procedures, each item should be discussed, in detail, with responsible officials.

Solution 5

a. An audit program for examination of income taxes would include the following steps:

(1) Prior year's liability

(a) Obtain and review copies of income tax returns filed for the period for which the statute of limitations has not run or for which the statute has been waived. If questionable items appear, discuss with client and consider an additional accrual.

(b) Inspect the cancelled checks for payment of the preceding year's income tax and agree the total amount with the tax shown on the return.

(c) Determine the last year examined by a revenue agent. If an examination has been made and any tax adjustment not settled, obtain the details of the proposed adjustments and determine whether a deficiency for the period examined should be recorded, including also the effect of the examination on subsequent years not yet examined and the current year under audit.

(d) Determine whether any overassessments indicated by the above steps should be recorded.

(2) Current year's liability

(a) Test the accruals for federal (and state, if applicable) income taxes by independent calculation. Tie-in the amounts accrued with the expense accounts.

(b) If there are abnormal or questionable deductions or exclusions from income, determine the additional tax which would be due if such deductions were excluded and/or such income included and consider whether any additional provisions should be made therefor.

(c) Determine whether the company is entitled to any net operating loss or capital loss carry-over from prior years by reference to prior year's returns.

(d) Determine whether the company has provided for income taxes in all states in which it is liable, by comparing the provisions made for taxes with the states having income taxes in which the company operates.

b. A satisfactory balance-sheet presentation might be as follows:

(1) Federal income taxes payable:

Current year	$420,000
Prior years (1952-1954)	70,000

It would be permissible to combine the payable into one amount of $490,000 with the prior year's portion indicated.

(2) Federal income taxes payable:

Current year (see note)	$400,000

Note to Financial Statements—The Internal Revenue Service has disallowed a portion of the depreciation deductions claimed in prior years on certain fixed assets. In the opinion of counsel, the disallowances are based on findings which are without merit. Since the disallowances are being contested and the ultimate outcome of the controversy is uncertain, no provision has been made for possible additional income taxes arising from such disallowances. The maximum additional tax liability involved is $90,000, and the maximum applicable to 1955 is $20,000.

Solution 6

The long-form report is not standardized as to content or form. It is expected to provide information and financial data which will be helpful to the reader in forming an opinion on the financial position and operating results of the client. In this instance the report is being prepared for the bank which is a creditor of the company. This knowledge of purpose permits some limitation as to the type of material which might be included.

Long-form reports are expected to include a balance sheet, income statement and surplus analysis. While some accountants include comments on the principal procedure followed in the audit, such comments are clearly not what is sought by the question because of its reference to the statements.

The following answer assumes the ordinary situation for a manufacturing company. If there were unusual features in this particular company, they would also be included in the statements or comments. Some of the suggested information might be in the body of the statements or in footnotes, while other information might be in the comments.

Accounts receivable:

These should be segregated on the balance sheet between trade accounts, amounts due from officers or affiliates, and miscellaneous amounts. Any amounts not due currently should be classified as non-current assets. The allowance for doubtful accounts should be deducted from the receivables to which it applies and the amount of the reserve should be indicated. Any accounts assigned or pledged should be adequately described.

The report comments should show a summary of aging of trade accounts according to customary 30-, 60- and 90-day periods, etc.; and an aging of any other accounts receivable of material amount. A statement as to the adequacy of the allowance for doubtful accounts may be included, and if the reserve is considered inadequate or excessive that would be pointed out in the report.

Inventories:

The total should be broken down in the balance sheet according to the stages of manufacture; supplies, raw materials, goods in process, and finished goods. The basis of valuation should be shown for each class of inventory. The report comments should indicate whether the inventories are based on physical counts and the date of these counts. The amount and type of slow-moving inventory, if material, should be indicated. Turnover may be computed and discussed.

Investments:

These should be adequately described in the balance sheet and whether they are carried at cost or market should be stated (if at cost, market value in some cases may be shown parenthetically). Investments in and advances to subsidiary companies not consolidated should be shown separately from other investments with the basis at which they are carried stated and the underlying book value indicated. Securities pledged as collateral to loans, etc., should be designated.

Property and equipment:

The main classifications, such as land and buildings, machinery and equipment, furniture and fixtures, etc., should ordinarily be shown in the balance sheet. If there are many classifications, however, they may be detailed in the report comments or in a separate schedule and summarized in the balance sheet. The allowance for depreciation should be deducted from the cost of the property and equipment. The report comments should contain a summary of the beginning balances, additions, reductions, and ending balances for property and related depreciation allowances. A brief description of the method used in computing depreciation should be given and the rates applicable to property and equipment should be stated. Major acquisitions or retirements of property during the period may be detailed in the comments.

Current liabilities:

Notes payable should be classified in the balance sheet as to those due banks, affiliates and others. Secured liabilities and the related assets pledged as collateral should be appropriately designated on the balance sheet. Accounts payable to trade creditors and others should be shown separately. Accrued interest, taxes other than income taxes, salaries, and bonuses, etc., should be listed separately as well as the accrual for income taxes. The report comments should give additional information on notes payable in regard to the dates of the notes, due dates, interest rates, and possibly the names of payees.

Long-term debt:

A description of the bonds or notes with the maturity dates and interest rates should ordinarily be included in the balance sheet. The comments in the report should contain data as to restrictions or requirements imposed by mortgage indentures, or loan agreements, call prices, sinking fund provisions, etc.

Capital stock and surplus:

Each class of stock should be described in the balance sheet as to par or stated value, number of shares authorized, issued, outstanding and in treasury. Preferred stock should be described as to whether it is cumulative, convertible and callable. Conversion rights, call price or preference in liquidation should be indicated. The amount of any arrearage in dividends on cumulative preferred stock should be shown in a note to the balance sheet. Any stock purchase plans in effect for officers or employees should be discussed in the report comments. If stock has been issued or retired during the year, the basis of the transaction should be described.

Capital surplus and retained earnings should be shown separately in the balance sheet. Information as to the nature of the capital surplus and the year of its origin may be included in the comments of the report if the amounts are significant. Reference to footnotes or comments explaining restrictions on surplus should be indicated in the balance sheet.

Solution 7

Program for "Common Trust Fund":

(1) Investigate and write comments regarding internal control. Examine the fund's "Charter" or other documents which set out the policy of the fund as to type of investments, nature of expenses to be charged against it, etc. Obtain excerpts of minutes of directors' meetings.

(2) Obtain a list of all securities held by the common trust fund as of December 31, 1955 and physically inspect and check them to the list.

(3) Arrange for client's personnel to compute (a) the cost and market value of each security, (b) the interest and dividend income for each security, and (c) the amount of income and capital gain or loss to be distributed to each individual trust fund based on shares they hold in the common trust fund.

(4) Check the client's schedules prepared in (3) above, as follows:

  (a) Check market value of the securities by reference to published quotations for each security, preferably using a source other than that used by the client. Prove extensions and footings. Determine the net book value of the fund based on market value of securities.

  (b) Check income earned by computing the amount of interest earned on bonds and dividends received during the period. For stock, reference should be made to one of the dividend services for dividends declared during the period. Give attention to the record date for the dividends. Prove all extensions and footings.

  (c) Determine earnings per share and verify amount earned by each individual fund based on shares held.

(5) Audit purchases and sales of securities during the year as shown by the subsidiary ledger (by test, only if numerous) by reference to:
  (a) Cancelled checks.
  (b) Statement from brokers (also test prices per brokers' statements to published quotations to ascertain that the price was within that day's range).
  (c) Authorization of the trust department directors.

(6) From the above, compute capital gain or loss on the sale of securities. Determine that proper adjustments have been made for stock dividends, split-ups, rights, etc.

(7) Determine capital gain or loss per share and test computation of the amount applicable to each trust fund based on shares held.

(8) Check investments or withdrawals by the individual funds by reference to deposit slips, cancelled checks, etc., and also determine that such action was approved by the directors. Confirm (on a test basis) these transactions by reference to the individual trust fund ledgers. (If we did not audit the fund at the time of these transactions, it will be necessary to verify the net book value of the fund to determine the value per share for purposes of investment or withdrawal.)

(9) Reconcile the bank account at December 31, 1955 and obtain certification of the balance.

(10) Check (test, if many) any other transactions in the fund (payment of expenses, receipts of dividends and interest, etc.) by reference to cancelled checks, approved invoices and deposit slips. Determine that there was proper accounting for dividends and interest received during the period. (That is, that it was taken through accrued income accounts where applicable.) Determine the reasonableness of accrued expenses.

(11) Determine that all transactions are properly within the scope of the fund policy as noted in (1).

(12) Ascertain if any bonds are in default as to principal or interest.

(13) Obtain a certificate from officers of the fund certifying that all known liabilities have been provided for, that there are no contingent liabilities, etc.

Commercial Law

May 11, 1956; 9 a.m. to 12:30 p.m.

GROUP I

Solution 1

The implied warranties imposed on sellers are as follows:

a. Title. The seller impliedly warrants (1) in a sale that he has the right to sell the goods, and in a contract to sell that he will have such right when the property is to pass; (2) that the buyer shall have and enjoy quiet possession; and (3) that the goods are free from any charge or encumbrance not declared or known to the buyer at the time of contract or sale.

b. Description. In a contract to sell or a sale of goods by description, the seller impliedly warrants that the goods shall correspond with the description, and if the contract or sale be by sample as well as by description, the bulk of the goods must also correspond with the sample.

c. Quality. In a sale or contract to sell, if the buyer informs the seller of the purpose for which the goods are purchased and relies on the seller's skill or judgment, the seller impliedly warrants that the goods shall be reasonably fit for the purpose. When the goods are bought by description from a dealer in goods of that description, there is an implied warranty that the goods shall be of merchantable quality. Also, an implied warranty as to quality or fitness may be annexed by the usage of trade.

If the buyer examines the goods, there is no implied warranty as to defects such examination should have revealed. Where an article specified by its patent or other trade name is involved, there is no implied warranty as to its fitness for any particular purpose.

d. Sample. In a sale or contract to sell by sample, there is an implied warranty that the bulk shall correspond with the sample, in quality, and an implied warranty that the buyer shall have a reasonable opportunity of comparing the bulk with the sample (except as otherwise provided in subsection 3, Section 47). If the seller is a dealer in such goods, there is an implied warranty that the goods shall be free from any defect rendering them unmerchantable which would not be apparent on reasonable examination of the sample.

Solution 2

No, Smith's claim is not valid. Mere indulgence upon the part of the creditor, or passively permitting the debtor to take more time than the contract calls for, does not release the surety. The latter is in no sense injured by such conduct, because he is free at any time to perform on his part and immediately start suit against the principal. The surety is not discharged unless there is a binding agreement between the principal and the creditor for a definite period of extension. In this situation Chase did not enter into a binding agreement with Partridge for an extension of time. Chase had no obligation to advise Smith of the failure of Partridge to pay the debt because Smith, as surety, is liable simultaneously with Partridge and is chargeable with knowledge of default.

Solution 3

Yes, Smith can force Gale to perform by a suit for specific performance.

As a general rule, specific performance of a contract concerning stocks or bonds will not be decreed unless damages at law are clearly incomplete and inadequate. But where justice demands it, such a contract will be specifically enforced. Here the contract calls for the transfer of stock that will result in Smith's having control and being able to determine the management, so that its value cannot be readily measured. Also because of the limited number of shareholders, no satisfactory measure of value is possible. In such circumstances there is not an adequate remedy available at law and specific performance may be directed.

Solution 4

a. The first mortgage is the $20,000 mortgage. It is called "first" because it is both first in time and takes precedence as the senior mortgage lien on the property. The second mortgage is the one for $5,000. It is called "second" because it is both subsequent in time to the first and junior to the first as a mortgage lien on the property. The purchase money mortgage is the one for $5,000. It is so called because it was given to secure the unpaid portion of the purchase price. The term would not apply to the $20,000 mortgage.

b. The holder of the first mortgage of $20,000 will receive the entire $19,000. The $5,000 second mortgage is subject to the existing mortgage and entitled to proceeds from the property only after full payment of the first mortgage.

c. Normally Wilson would be liable for the unpaid amount of $1,000 on the first mortgage. As the original borrower, he signed a bond (note) for the $20,000 with the mortgage serving only as security. Sale of the property does not relieve him of this primary obligation except to the extent that proceeds of the sale pay the obligation. Wilson was not a party to the second mortgage and has no liability as to the $5,000.

Steel has no liability to the holder of the first mortgage and therefore no liability for the $1,000 deficiency relating to it. When he originally took the property *subject* to the first mortgage, he did not impliedly or expressly *assume* that mortgage and agree to pay it. However, Steel is liable to the holder of the second mortgage for any part of his original debt of $5,000 which is still unpaid. When he acquired the property Steel became liable for a debt of $5,000 on a bond or note which was secured by the mortgage. Since on foreclosure there was nothing available to apply toward the second mortgage, Steel is liable for the full $5,000 of the obligation for which he gave the second mortgage.

Solution 5

a. Gold may not recover under the first insurance policy. A person has an insurable interest in property when he has an equitable title to the property insured, and so a mortgagee has an interest that may be validly protected by insurance. But in order for the insurance to be valid an interest must exist at the time of the loss. Since Gold did not have such an interest, he may not collect.

b. Gold may recover (except in Texas) the proceeds of the life insurance policy. Any person so related to another by contract or commercial association that a right possessed by him will be extinguished or impaired by the death of that other may lawfully procure insurance on the other's life. A creditor may insure the life of his debtor. *The existence of an insurable interest at the time the life insurance policy is issued is sufficient.* The subsequent termination of such interest before the maturity of the policy in no wise affects its validity. (In Texas a beneficiary without insurable interest at maturity of the policy may not retain the proceeds.)

Solution 6

a. The compensation is in the nature of insurance. Each employer is usually required to obtain insurance to secure payment of the insurance either through a state insurance fund or through private insurance companies. In this way losses are pooled and the burden is shared by the entire industry to which the employer belongs. The employer may be permitted to assume the risk himself (self-insurance) provided he furnishes satisfactory security or proof of financial responsibility.

b. Farm laborers and domestic servants are usually excluded from the provisions of the law.

c. (1) In such a case, compensation is paid without regard to whether the employer or the employee was negligent.
   (2) Generally no compensation is allowed for a willfully self-inflicted injury.
   (3) Generally no compensation is allowed for an injury received while intoxicated.

Solution 7

a. The measure of damage under the Securities Act is the difference between the amount paid for the security, but not exceeding the price at which the security was offered to the public, and the actual value of the security at the time the suit was brought, or the price at which the security was sold in the market before suit.

b. The Federal Securities Act of 1933 provides for liability for false registration statements involving the making of an untrue statement of a material fact, or the omission to state a material fact required to be stated therein, or necessary to make the statements therein not misleading. This liability is applicable to an accountant who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any paper or valuation which is used in connection with the registration statement. But there is no liability where the person charged with the misstatement had reasonable grounds to believe and did believe that the statement was true.

Solution 8

In effect, Spade raises the point that the instrument cannot be enforced by Paddy as it was not negotiable, being conditioned by the warranty. The bank contends that complying with the depositor's instructions releases it from liability to any holder of the check.

Spade's defense is invalid. Under subsection 2, Section 1 of the Uniform Negotiable Instruments Law one requirement of negotiability is that the instrument contain an unconditional promise or order to pay a sum certain in money. Subsection 2, Section 3 of the Law states that an unqualified order or promise to pay is unconditional, though coupled with a statement of the transaction which gives rise to the instrument. The notation on Spade's check is a mere reference that neither conditions nor qualifies.

If Spade also claims that the breach of warranty is a defense against the holder of a negotiable instrument, his claim fails since Paddy is a holder in due course and personal defenses of Spade against Smith relating to failure of consideration, breach of contract and fraud in the inducement cannot be maintained against Paddy.

The bank's defense is valid. A bank refusing payment pursuant to its depositor's order has no liability to the holder of a check because it is simply carrying out instructions as an agent. Even when a depositor has not stopped payment, a bank owes the holder of a check drawn on it no duty of payment unless the check has been certified. In case of a bank's refusal to pay, the holder's recourse is against the drawer, and the drawer, for unwarranted refusal, has recourse against the bank.

Solution 9

a. Actual fraud is fraud based on a misrepresentation of fact with intent to deceive. Constructive fraud is based on a violation of duty, and exists, regardless of intent to deceive, as a matter of law declared by the court and not as a matter of fact determined by a jury.

b. The basic elements are (1) intention to mislead, (2) misstatement, (3) materiality, (4) reliance upon the statement, and (5) injury to the party defrauded.

c. Fear of injury, induced by a threat, constitutes duress. Abuse of confidence, by one in a trust relationship or in authority who takes advantage of another's weakness of mind, or an oppressive or unfair advantage of another's necessity and distress, constitutes undue influence.

d. Silence, where the one silent is under a duty to the other party to reveal what he knows (as in the case of a fiduciary relationship), may be fraud.

e. The defrauded party may rescind the contract by promptly tendering back all that he has received under it. He may then bring an action at law upon the rescission to recover back what he has paid, or (2) defend an action brought against him on the contract, setting forth the fraud and rescission as a defense. (3) He may bring an action in equity for rescission; the tender may be made in the complaint and must be kept good at the trial, and the court will adjust the relief as equity requires upon the facts established. (4) He may affirm the contract and sue for damages. (5) If sued upon the contract, he may counterclaim his damages.

Solution 10

a. (1) A unilateral mistake occurs when only one of the parties to a contract is contracting under the mistaken belief that certain facts exist which do not exist.

(2) As a general rule, no relief will be granted. This rule is subject to many exceptions. If one party knows that the other party is mistaken in his belief that certain facts exist and enters into the contract for the purpose of taking advantage of the situation, the courts will grant relief. The courts will also grant relief where hardship amounting to injustice would result if relief were denied.

b. As a general rule, the word "fraud" is used to signify a misrepresentation knowingly made, while the word "misrepresentation" is used to signify innocent misrepresentation. Hence, the basic difference is that in an innocent misrepresentation there is no knowledge of falsity, while in a fraudulent statement there is.

c. The old general rule is that as "ignorance of the law" excuses no one, mistake of law is not ground for relief. While under special circumstances tending to show misrepresentation, overreaching of a person inferior in mentality and experience, or breach of trust, a court of equity may grant relief, in a case where there is only a simple mistake by a person as to the legal effect of an agreement, with no other circumstances inclining the court toward granting relief, the court will not ordinarily permit the mistake to be a defense or ground to set aside the contract.

d. Yes. Mistake (mutual) may constitute ground for avoiding a contract. A mistake as to the subject matter of the contract is ground for avoidance. Mistake as to subject matter is limited to the existence or identity of the subject matter.

Solution 11

a. Ames may exercise the right of stoppage in transit by obtaining actual possession of the goods or by giving notice of his claim to the carrier. After recovery of possession, Ames may (1) resell the goods if the sales contract gives him the right to do so, or if the goods are perishable, or if Burr has been in default in payment for an unreasonable time, or (2) may rescind the contract and keep the goods if he expressly reserved such right or Burr has been in default as to payment for an unreasonable time.

b. Yes. Delivery of the goods to Burr ends the right of stoppage in transit. Goods are in transit only from time of delivery to a carrier until the buyer takes delivery from the carrier.

c. No. If a negotiable document of title has been issued for goods, no right of stoppage in transit shall defeat the right of any purchaser for value in good faith to whom such document has been negotiated, whether such negotiation be prior to or after notification by the seller to the carrier.

d. Yes. Ames' right to stop the goods in transit depends upon Burr's actually being insolvent. The right is based on the buyer's insolvency. If the seller stops the goods in transit and reclaims them and the buyer is not insolvent, the seller is liable for failure to deliver the goods.

Solution 12

a. (1) False
(2) True
(3) True
(4) False
(5) False
(6) True
(7) False
(8) True
(9) True
(10) False

b. (1) True
(2) True
(3) False
(4) True
(5) False
(6) True
(7) False
(8) False
(9) True
(10) True

Theory of Accounts

May 11, 1956; 1:30 to 5 p.m.

Solution 1

The profit-and-loss ratio should govern.

The agreement with respect to sharing of profits and losses is an unqualified agreement. Since the agreement is not expressly limited to operating profits or losses, to apply any such limitation would not be in accord with the agreement.

The partnership is not dissolved merely by the decision to discontinue operations, and the agreement concerning the division of the partnership profits and losses is still in effect.

All losses are losses of capital. The profits or losses from operations which have been divided are merely periodical estimates. The ultimate profit or loss on the partnership is not definitely determinable until the partnership is dissolved. The loss or gain on dissolution is a correction of all previous periodic estimates, and it also should be divided in the profit-and-loss ratio.

Solution 2

Under the rule of "cost or market" which would be appropriate here a figure must be established for cost and a figure for market. Since there is not a market in the sense of cost of replacement, market would be derived from sales value.

To determine cost, a decision must be made as to whether the "Overallowance" should be deducted in full or in part from cost, and a decision must be made as to whether service department charges should be at cost or at billing price. Generally, accounting requires that in the case of a trade-in, where "list" price is above the usual cash price, the cash price should govern. If, for example, car number 1 was a "trade-in" on a car listing at $3,000, and $1,300 cash and the used car were received, the transaction might be considered as though the sale price were $2,700, with $1,300 cash received and a used car received for $1,400. The service cost should be added to the net cost of the trade-in at its actual cost to the business under the theory that no interdepartmental profit should be recognized. This approach produces a cost of $1,445 for car number 1, $2,100 for number 2, $830 for number 3, and $1,320 for number 4.

In determining market under the cost or market rule, market should not exceed the net realizable value or be less than net realizable value reduced by an allowance for an approximate normal profit margin. While there may be a wholesale market for used cars, our data do not indicate such market prices. Therefore market must be determined from or checked against net realizable value.

To determine net realizable value the estimated cost of disposal is needed. In this instance we would need to know the amount of selling expenses (commissions, advertising, sales, salaries, etc.) which will be incurred to sell the cars.

Also we have to decide which of the probable sale prices to use. While the N.A.D.A. figures at time of trade-in are not appropriate at statement date, either the N.A.D.A. estimates at audit date or the estimates made by the business may be considered. For cars 1 and 3, the retail prices have been established by actual sales and those prices are appropriate. For cars 2 and 4 we find the N.A.D.A. figures higher than the business' estimate on number 2 and lower on number 4. Since the difference is not large and the N.A.D.A. figures are only averages, use of the dealer's estimates may be justified if he has a reasonable basis for the $1,300 price on car number 4.

It appears reasonable in this instance to compute "market" for the cars at the amounts of the probable sales prices ($1,600, $2,150, $825 and $1,300) less cost to sell. The lower of these figures and costs of $1,445, $2,100, $830, and $1,320 should be used in the inventory if it is not considered that a profit should be made on used car sales. If a profit should be provided for in the inventory valuation, "market" would be further reduced to provide for the normal rate of return on used car sales, in accordance with the rule expressed above as to the meaning of market.

Solution 3

a. The more commonly encountered advantages of filing a consolidated tax return are the following:

(1) One company's loss would be offset against another company's gain.
(2) Intercompany profits are eliminated.
(3) Capital gains in one company could be offset against capital losses in the second company.
(4) Intercompany dividends are eliminated.
(5) Foreign tax credits may be absorbed by reporting consolidated income.
(6) If one company has a short taxable year the short term income would not necessarily have to be annualized.
(7) Computation of improper accumulation of surplus would be made on a consolidated basis.
(8) No trouble is incurred in allocating expenses, while there could be difficulty without consolidation.

b. The common disadvantages of filing a consolidated tax return are as follows:

(1) The tax is two per cent higher.
(2) The consolidated return has only one $25,000 surtax exemption, whereas two or more exemptions could be obtained by filing individual returns.
(3) The corporation is held to the election to file a consolidated return until permission to change this election has been granted by the Commissioner of Internal Revenue.

(4) If an error is disclosed in the computation of one company's income the statute of limitations is extended for all companies.
(5) An operating loss carry-over from a separate return may be substantially reduced when a consolidated return is filed.

Solution 4

a. A number of considerations enter into a decision as to whether to capitalize or expense an item. Not all of them have equal weight in all instances and it is most important that a reasonable policy be established and followed consistently if distortion of income is to be avoided. The usual principles applicable are:
(1) Length of probable life in relation to the usual accounting period. Items which will last beyond the current accounting period, thereby benefiting future periods, should be capitalized to avoid understating current income and overstating future income.
(2) Materiality of the amount involved, and frequency and regularity of purchase. Items costing relatively small amounts, especially if the business purchases similar items frequently, may be expensed without distorting income. If the aggregate cost of such items is material and purchases are not uniform from year to year, the items should be capitalized if of long life.
(3) Expenditures which prolong the expected life of an asset, or increase its usefulness beyond the original usefulness, should be capitalized.
(4) Expenditures for items which should be controlled should be capitalized to insure better accountability.
(5) Depreciation policy. The treatment of expenditures will depend in part on the depreciation policy followed by the business. If relatively high rates are used, expenditures which "make good" depreciation may be capitalized, whereas with lower rates the items should be expensed.
(6) Cost of accounting. One factor which affects policy as to capitalizing items is the cost of accounting for them if they are capitalized. It may be that the cost of setting up, depreciating and retiring items of small value is so great as to dictate expensing them.

b. (1) The distribution is correct. A band saw has a short life span and so is a proper expense charge. If the mill maintains an accurate cost accounting system the charge might be made to a prepaid expense account and amortized over a one-year period to avoid costs being out of line from month to month. If the band saws were for a newly constructed mill, they would be properly charged to a fixed asset account, and would be depreciated by means of the composite rate used in writing off the cost of the sawmill as a unit.
(2) The distribution is correct. A truck will be used during more than one accounting period, and is therefore a proper fixed asset charge.
(3) The distribution is correct. The item should be handled similar to the band saw discussed in item 1.

(4) The distribution is correct for that portion of the expense applicable to company business conducted by Mr. Jones. The expense applicable to Mrs. Jones, and that portion of his expense while on personal travel, should be charged back to Mr. Jones. The distribution of the personal portion should be—Accounts receivable—R. L. Jones.
(5) The distribution is not correct. Charge should be made to Accounts receivable—Sales manager. Personal accommodation purchases should never be charged to an expense account unless the company agrees to absorb them and in that case they should be charged as a part of compensation.
(6) The distribution is incorrect. The charge should be made to the Sales account, which has the effect of offsetting the original error.
(7) The distribution is incorrect. The item purchased will last more than one period and should be charged to the Fixed assets account and be amortized over its estimated useful life.
(8) The distribution is incorrect. The purchase is a part of the cost of the new facility, and should therefore be charged to the Fixed asset account which receives other expenditures in connection with construction of the kiln.
(9) The distribution is correct. Replacement chain is an expense item similar to band saws and brick for steam plant—refer to items 1 and 3.

Solution 5

In order to stabilize production it will be necessary to provide for storage of sizeable amounts of finished goods. Raw materials inventories can be held relatively constant in either case.

a. The principal advantage of stabilizing inventories is that the investment in inventories can be kept at a consistent minimum. This would reduce the risk of loss from price declines and reduce the following expenses:
  (1) Interest on borrowed capital
  (2) Storage and handling
  (3) Insurance on inventories
  (4) Property taxes

b. By stabilizing production, the following production costs will be kept at a minimum:
  (1) Overhead costs of excessive productive capacity. If production is stabilized and the larger quantity sold in the peak season produced for inventory in advance of the season, the productive capacity, and overhead costs incident thereto, may be kept at a minimum. A plant with smaller capacity may be more desirable even with an annual peak in working capital requirements than a permanent increase in sunk capital. Part of the minimum productive capacity required when production is stabilized would be idle a good part of the year if production fluctuates with sales. Costs incident to idle capacity could be kept at a minimum by stabilizing production.

(2) Costs incident to fluctuating production can be avoided. These would include:
   (a) Overtime premiums for regular employees
   (b) Labor turnover costs such as: Hiring new employees; Training new employees, including wages, material and overhead
   (c) Spoiled production and inefficient use of productive capacity

   In view of the high proportion of total cost (60 per cent) that consists of skilled direct labor, items (a) and (b) may be of major importance especially in a "tight labor market." A 10 per cent saving in direct labor offsets a 30 per cent increase in overhead for this particular company. Also since a part of overhead is indirect labor, some saving on overhead can be achieved by stabilizing production.

Solution 6

The two entries do not reflect properly the facts relative to the pension plan. The first entry is in error in two respects. The entire liability of $25,000 to cover the cost of pensions based on past services should be recorded and the offsetting charge should not be to Retained earnings.

The entire liability should be recorded because at the moment there is a contractual liability to pay this total amount of $25,000, although payments may be spread over five years. A possible alternative would be to disclose the contract in a footnote to the balance sheet. The entire offsetting charge should have been made to an account such as "Deferred pension costs." The balance of this account would be reflected on the asset side of the balance sheet. This Deferred pension costs account should then be amortized by charges to operations over the present and future periods, because, as expressed in AIA Accounting Research Bulletin No. 36, "costs of such annuities based on such services are generally incurred in contemplation of present and future services." The period of time over which these costs should be amortized would depend upon the circumstances in the individual case. For federal income tax purposes they are deductible over a period of ten years, which may be a reasonable period for general accounting purposes. A correcting entry for this first item then would be:

Deferred pension costs	$22,500	
Pension costs	2,500	
Retained earnings		5,000
Pension costs payable		20,000

The second entry is correct in that the current pension cost should be charged to operations, but it is not desirable to include this charge as part of the Factory wages account. The $3,000 should have been charged to a separate account, such as pension costs, in order adequately to disclose the nature of the cost. Assuming that the entire amount applies to factory operations, this account would be included among the factory overhead items in the statement of production operations.

Solution 7

a. Generally, it is assumed that the percentage of completion of a given project may be obtained by dividing the total current estimated cost of the entire contract into the amount of cost incurred to date. This percentage is multiplied by the total contract price to obtain the income to be recognized. The actual costs are then subtracted to obtain income after deduction of contract costs.

b. (1) Retained percentages receivable represents an amount due the contractor which will not be collected until the project is complete. The contract provides that the owner will retain a certain percentage of each progress billing until the contract is satisfactorily completed.

(2) Subcontractors' estimates payable represents amounts payable to other contractors for performance of part of the construction work which was a part of the original prime contract and which has been subcontracted.

(3) Bid deposits is the account to which certified checks or cashier's checks are charged when the owner of the project requires that the bidding contractors submit deposits with their bids.

(4) Contracts in progress is the controlling account for the costs incurred on incomplete contracts.

Solution 8

General Price Index

The use of a general price index will reflect the general purchasing power of the items as converted without consideration of the specific uses to which they may be put. It is argued that statements so converted will be more meaningful for most purposes and to most parties. The converted figures for one enterprise can be compared with the converted figures for another business, even though of a different type. This would not be possible if different specific indexes were used in the conversion procedure for each of the enterprises. The use of a single price index by everyone would reduce the confusion that might arise if various specific price indexes were used by different business enterprises.

The converted figures would not represent the replacement costs of an asset unless, by coincidence, the general price index should be the same as the specific price index for this particular asset. Those who advocate using the general price index hold that replacement cost should not be the goal of this conversion process because many assets are not replaced, or at least the new assets acquired to replace the old are so much different that the use of a specific price index would not necessarily give more reliable results. They hold that when any asset is retired, it is a managerial decision as to whether to replace or not; that the cost data converted by the use of a general price index gives a reliable measure of the general purchasing power involved and that the use to be made of this purchasing power is a matter of managerial decision.

Specific Price Index

Those who favor the use of specific price indexes for each industry, or different specific indexes for conversion of different items within an industry, are probably most concerned with replacement costs, particularly of plant and equipment. The use of a specific price index would give a better measure of such replacement costs. They hold that, by and large, plant and equipment are replaced, and they are concerned with showing replacement costs in the balance sheet, and in charging operations with depreciation based on such replacement costs, and hence retaining out of revenue a sufficient amount to provide for replacement. This technique is particularly applicable if only such items as inventories and plant and equipment are to be converted, rather than a complete conversion of all items in all statements.

Solution 9

a. The "expected capacity" is the rate of output expected for a particular accounting period. It considers current production requirements and therefore may or may not anticipate and provide for there being unused plant capacity since that depends on the anticipated sales and inventory requirements.

The "average capacity" is similar to the expected capacity except that it is based on operations over a period of several years. For that reason it will provide for some idle plant capacity and will usually vary from the short-run "expected capacity" rate.

The "practical capacity" is based on the rate of operation without allowance for idle plant capacity because of lack of work. It does provide for normal breakdowns, lost time, etc., which are inevitable in plant operations.

b. Overhead incurred may vary from overhead applied because of differences between the budget amounts and actual amounts spent, or because of the application basis used. The nearer the actual rate of operation is to the assumed operation used in setting the overhead rate, the smaller will be the variation caused by the basis.

When a firm uses expected capacity, there is a tendency for that firm to absorb all of the factory overhead into the product. As a result, the only balances which tend to remain are those which arise because of an over- or under-incurring of overhead costs as compared to the budget.

In a similar manner, average capacity tends to absorb all of the overhead; however, to the extent that the average is not met or exceeded in any accounting period it will give rise to a balance in the overhead account from that cause as well as from over- or under-incurring costs as compared to the budget.

In contrast, the use of practical capacity overhead rates tends to emphasize that the activity of the firm at any level below practical capacity has a cost to be associated with it. Therefore, the overhead balances will be made up of two parts—the cost of not producing up to the best capacity and the over- or under-incurring of costs.

The expected capacity and average capacity bases assume as normal a certain amount of idle capacity and do not, therefore, attempt to segregate this amount and bring it to the attention of management; whereas, the use of practical capacity attempts to isolate costs associated with under-capacity operations.

Solution 10

a. This account is utilized to indicate the portion of the total amount receivable from customers that will not be collected due to the deduction of cash discounts by these customers in settling their accounts. The account may be handled in two ways. (1) All cash discounts actually taken during the period are debited to "Cash Discounts on Sales" (or some comparable title). At the end of the period an estimate is made of the additional discounts which will be taken in settlement of remaining accounts receivable, and this amount is debited to "Cash Discount on Sales" and credited to "Allowance for Cash Discount on Sales." (2) As an alternative technique, all discounts taken during the period may be debited to "Allowance for Cash Discount on Sales." At the end of the period an entry is made debiting "Cash Discount on Sales" and crediting "Allowance for Cash Discount on Sales" for the estimated discounts on the *total sales* for the period, based on past experience of discounts taken. In either case, the "Allowance for Cash Discount on Sales" account will be left with a credit balance at the end of the accounting period equal to the estimated discounts applicable to the remaining accounts receivable. If method (1) is used, an entry as of the first of the succeeding period reversing the entry for the estimated additional discounts will prove to be a useful device but the amount may be left on the books until the end of the next period and then adjusted. No such reversing entry would be involved if method (2) were used.

b. This account is subtracted from "Accounts receivable" (together with allowances for bad debts, etc.) in order to measure as accurately as possible the amount that will actually be collected from the customer.

c. Use of the account is justified primarily because it reflects cash discounts in the period in which the sale is made, rather than in the period in which payment is made. Thus it provides for a better "matching of costs and revenue." A second justification is that its use gives a more accurate measure of the amount to be realized from accounts receivable. Principal objections to the method are: (1) the procedure used requires estimates of cash discounts to be taken, which reduces the reliability of the results; (2) the procedure is not acceptable for tax purposes; and (3) the practical effect of the method on income is likely to be negligible and therefore the computations and work required are not justified by the results obtained.

Answers to Examinations, November 1956

Accounting Practice—Part I

November 7, 1956; 1:30 to 6 p.m.

Solution 1

This problem requires the solution to be submitted on a 1956 Federal Partnership Return of Income. Form 1065 is not being reproduced in the following solution but all appropriate items are listed. Each is labeled with the page, schedule and/or line number or title as shown on the official tax form.

Page	*Line*	*Schedule*							
1	1								$181,300
	8								181,300
	9								82,000
	10								42,000
	11								7,500
	12								1,670
	13								2,750
	17								2,955
	20								29,270
	21								168,145
	22								13,155
	25(a)								900
	30								300
2	1	A							181,300
	3								181,300
	7	D	6/1/51	4/30/56	$9,900	$9,000	$18,000	$——	900
	9								900

3 G

	(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*
	Office Equip.	6/ 1/51	18,000	8,100	SL	10 yrs.	900
	Office Equip. (new)	4/30/56	22,000	—	SYD	10 yrs.	2,000
	Office Equip. (used)	4/30/56	1,100	—	SL	10 yrs.	55
	Total						2,955
I	Community Fund						300
J	11,000	—	300	4,385	610	—	15,075
	1,300	1,000	300	4,385	610	—	6,375
	2,600	1,000	300	4,385	610	—	7,675

Page	*Line*	*Schedule*	*Col. 1*	*Col. 3*	*Col. 4*	*Col. 7*	*Col. 10*	*Col. 12*
		K						
		(a)	Sawyer	4,385	18,000	300	100	22,385
		(b)	Mansville	4,385	12,000	300	100	16,385
		(c)	Johnson	4,385	12,000	300	100	16,385
			Totals	13,155	42,000	900	300	55,155

Page	*Line*	*Schedule*	*Beginning of Year*		*End of Year*	
4						
	1			15,600		8,930
	2		200		4,150	
	(a)			200		4,150
	5		18,000		23,100	
	(a)		8,100	9,900	2,055	21,045
	9			4,700		5,200
	10			30,400		39,325
	11			14,500		9,000
	14			1,000		1,200
	15		11,000		15,075	
			1,300		6,375	
			2,600		7,675	
				14,900		29,125
	16			30,400		39,325
	1	M				13,155
	2					42,000
	3					55,155
	8					55,155

SAWYER, MANSVILLE & JOHNSON Worksheet—Cash Basis August 31, 1956

	Trial Balance		Transactions		Profit & Loss		Balance Sheet	
	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
Cash	$15,600		(3) $ 9,900	(7) $ 40,000				
			(2) 50	(6) 5,500				
			(1) 177,300	(4) 23,100				
				(9) 81,800				
				(10) 7,500				
				(11) 1,670				
				(12) 2,750				
				(13) 31,600			$ 8,930	
Travel Advances—Employees	200			(2) 50			150	
Cash Value—Life Insurance	4,700		(13) 500				5,200	
Office Equipment	18,000		(4) 23,100	(3) 18,000			23,100	
Allowance for Depreciation		$ 8,100	(3) 8,100	(5) 2,055				$ 2,055
Notes Payable—Bank		14,500	(6) 5,500					9,000
Payroll Taxes Withheld		1,000		(9) 200				1,200
G. W. Sawyer, Capital		11,000						11,000
F. D. Mansville, Capital		1,300		(8) 1,000				2,300
L. J. Johnson, Capital		2,600		(8) 1,000				3,600
Notes Receivable			(14) 4,000				4,000	
Professional Fees				(14) 4,000				
Gain on Sale of Office Equipment				(1) 177,300		$181,300		
				(3) 900		900		
Depreciation			(5) 2,055					
			(3) 900		$ 2,955			
Partners' Salaries			(8) 2,000					
			(7) 40,000		42,000			
Employees' Salaries			(9) 82,000		82,000			
Rent			(10) 7,500		7,500			
Interest Expense			(11) 1,670		1,670			
Taxes			(12) 2,750		2,750			
Other Operating Expenses			(13) 31,100	(15) 1,830	29,270			
Non-deductible Expense:								
Contributions			(15) 300)					
Political Contribution			(15) 200)		1,830			
Life Insurance Expense			(15) 1,300)					
Parking Tickets			(15) 30)					
	$38,500	$38,500	$400,255	$400,255	$169,975	$182,200	$41,380	$29,155
Net Profit					12,225			12,225
					182,200	$182,200	$41,380	$41,380
Add—Non-deductible Items					1,830			
Less—Items Separately Taxed					(900)			
Taxable Profit					$ 13,155			

Explanations and Adjustments

Computation of opening capital:

Amounts omitted to convert to cash basis:

Accounts receivable	$ 74,000
Unbilled fees accrued	21,000
Supplies inventory	1,200
Prepaid interest	200
Allowance for doubtful accounts	(3,400)
Accounts payable	(8,500)
Accrued bonuses	(6,000)
Accrued taxes	(500)
	$ 78,000

Reduce each partner's capital by $26,000

1. Collections on Accounts receivable:

Fees billed	$186,000
Unbilled fees 9/1/55	21,000
Accounts receivable 9/1/55	74,000
	281,000
Notes receivable 8/31/56	(4,000)
Accounts receivable 8/31/56	(70,000)
Unbilled fees 8/31/56	(28,000)
Accounts charged off	(2,200)
	$176,800
Recovery of accounts charged off	500
	$177,300

2. Reduction in travel advances
3. Sale of office equipment
4. Purchase of new office equipment
5. Depreciation of new equipment:

½ of 10/55 of $22,000 =	$ 2,000
½ of 10% of $1,100 =	55
	$ 2,055

6. Reduction in notes payable
7. Payment of partners' salaries
8. Unpaid partners' salaries
9. Payment of employees' salaries and change in withheld taxes:

Accrued 9/1/55	$ 6,000
Accrued during year	85,000
	$ 91,000
Accrued 8/31/56	9,000
	$ 82,000

10. Rent paid

11. *Interest paid:

Prepaid 8/31/56	$ 650
Accrued during year	1,220
	$ 1,870
Prepaid 9/1/55	200
	$ 1,670

12. *Taxes paid:

Accrued 9/1/55	$ 500
Accrued during year	3,000
	3,500
Accrued 8/31/56	750
	$ 2,750

*Computations for schedules B and C.

13. Other operating expenses paid:

Supplies inventory 8/31/56	$ 1,300
Accounts payable 9/1/55	8,500
Accrued during year	28,000
	$ 37,800
Supplies inventory 9/1/55	1,200
Accounts payable 8/31/56	5,500
Expense	$ 31,100
Increase in C/S/V of life insurance	500
Cash required	$ 31,600

14. Notes receivable from customers taxable on cash basis
15. Separate non-deductible items

Solution 2

Statement of Surplus—Year Ended December 31, 1955

Earned Surplus

Balance January 1, 1955		$12,000,000
Net income for 1955		2,700,000
		14,700,000
Deduct dividends on common stock:		
Cash—50¢ per share	$ 500,000	
Stock—5%—50,000 shares of common stock at $25 per share (see note)	1,250,000	1,750,000
Balance December 31, 1955		$12,950,000

Capital Surplus

Balance January 1, 1955	$ 2,500,000
Excess of fair value over par value of 50,000 shares of common stock distributed as a dividend*	750,000
Balance December 31, 1955	$ 3,250,000

*The facts stated might be interpreted to mean that the 1,000,000 shares were outstanding after the dividend rather than before. This would change the computations but the principle applicable would be the same.

Note: The 5 per cent stock dividend (50,000 shares) was distributed to shareholders of record at the close of business on December 30, 1955. For the purposes of the dividend the stock was assigned at fair value of $25 per share based upon the average quoted market over a short period preceding the dividend date. The par value of $10 per share ($500,000) was credited to Capital Stock and the balance of $15 per share ($750,000) to Capital Surplus.

COMMENT:

Fair value has been based upon the average price over the two-month period, viz., $26. The issuance of 50,000 more shares would reduce the market to $24.76, assuming the aggregate market value remained the same. Rounding this out gives the $25 fair value used.

Average market has been chosen to eliminate the chance that any one day's market might have been affected by some unusual circumstances. Also in view of the relatively small size of the company, its stock is probably subject to wider market fluctuations than for a large company. This factor also indicates the desirability of using an average price.

Solution 3

a. The remaining basis of Doe's office building is considered to be the "substitute basis" of the two apartment buildings acquired, with appropriate adjustment of equity by reason of the respective mortgage liability.

Basis of office building			
Land		$ 50,000	
Building	$180,000		
Less accumulated depreciation	45,000	135,000	10 @ 2½
Adjusted basis		185,000	
Mortgage		125,000	
Equity in building		$ 60,000	

Allocation to apartment building

	Fair Market Value	*Allocation to Respective Properties*	*Allocation to Individual Assets*
Apartment building A			
Land	$ 46,000		$ 32,667
Building	92,000		65,333
Total	138,000		98,000
Mortgage	74,000		74,000
Equity (40% of total)	64,000	$ 24,000	24,000
Apartment building B			
Land	103,000		73,000
Building	103,000		73,000
Total	206,000		146,000
Mortgage	110,000		110,000
Equity (60% of total)	96,000	36,000	36,000
	$160,000	$ 60,000	$ 60,000

This is an exchange of property of like kind, and since Doe has assumed greater liabilities than that which he transferred there is no "boot." The exchange is taxfree as to Doe under Section 1031 of the Internal Revenue Code.

b. Mr. Roe has also exchanged property of like kind. However, he has assumed an indebtedness of only $125,000 while being relieved of an indebtedness aggregating $184,000. The $59,000 reduction in indebtedness is considered to be "other property or money," and his gain is taxable to this extent.

Solution 4

Since the basis of the stock in the hands of the distributee partners will be in proportion to the basis in the hands of the partnership, each partner should receive shares so that the total market value as well as the total basis will be on a 75 to 25 ratio. The worksheet follows:

Value of Stocks	*Market*	*Cost*
145 shares Anderson Company	$35,000	$14,500
45 shares Bellview Corporation	15,000	4,500
210 shares Crawford Stores	30,000	21,000
Total	$80,000	$40,000
To be distributed as follows:		
M—75%	$60,000	$30,000
N—25%	20,000	10,000
Total	$80,000	$40,000
Total to be distributed to M (75%)	$60,000	$30,000
Distributed by agreement (Anderson Co. stock)	35,000	14,500
Balance to be distributed	$25,000	$15,500

X = number of shares of Bellview stock to M
Y = number of shares of Crawford stock to M

The following two equations may be set up for M based on:

(1) Market: $\frac{15,000}{45} X + \frac{30,000}{210} Y = 25,000$

(2) Cost: $100 X + 100 Y = 15,500$

Solution of the two equations shows that: X equals 15 and Y equals 140. Therefore M will receive 15 shares of Bellview stock and 140 shares of Crawford stock.

The number of shares for N may be obtained by subtraction or similar equations may be solved for N.

ALTERNATE SOLUTION

Since the partners are interested in a distribution which will allocate market value and capital gain in the ratio of 75 to 25, the amount of gain may be used instead of "market" in the computation. Such a computation can also use the fraction of the total shares instead of the number of shares in equations. The following is an example of this approach:

	Cost	*Gain*
145 shares of Anderson Co. (to M)	$14,500	$20,500
45 shares of Bellview	4,500	10,500
210 shares of Crawford	21,000	9,000
Total	$40,000	$40,000
Amount for N (25%)	$10,000	$10,000

Distribution to N can be only from Bellview and from Crawford stocks. Therefore, let:

X = the fraction of Bellview shares for N

Y = the fraction of Crawford shares for N

4.5X (Gain) + 21Y (Cost) equals $10,000 cost which N must receive.

10.5X (Gain) + 9Y (Gain) equals $10,000 gain which N must receive.

Solving for X we have as a result of multiplying the equations by 9 and 21, respectively:

$$\begin{array}{rcl} 40.5X + 189Y & = & 90 \\ \underline{220.5X} + 189Y & = & \underline{210.} \text{ By subtraction we obtain:} \\ 180X & & 120 \\ X & = & 2/3. \text{ By substituting we obtain Y } 1/3. \end{array}$$

Applying these fractions we have:

2/3 of 45 shares of Bellview equals 30.

1/3 of 210 shares of Crawford equals 70.

In a similar approach Market and Gain might be used, the corresponding equations being:

$$\begin{array}{ll} (1) & 15X \text{ (Market)} + 30Y \text{ (Market)} = 20 \\ (2) & 10.5X \text{ (Gain} + 9Y \text{ (Gain)} = 10 \\ (3) & 135X + 270Y = 180 \\ (4) & \underline{315X} + 270Y = \underline{300} \\ & 180X \qquad = 120 \\ & \qquad X = 2/3 \end{array}$$

Also a correct distribution may be determined by "successive trials." In a simple situation such as this one, it will usually be the quickest method for solution. Such "trials" may start at various points, but a logical approach here seems to be the following:

1. After distribution of Anderson Company, there remains stock having $45,000 of market value of which M is to receive $25,000 and N is to receive $20,000. This ratio is 25 to 20 (or 5/9 and 4/9). Similarly the fraction based on cost is 155/255 and 100/255. We can then start our trials based on either cost or market values.

2. If we start with a trial based on cost, we proceed as follows: Give M 23 shares of Bellview and enough of C to bring his cost of stock received to $15,500. This produces:

	Shares	*Cost*	*Market*
Bellview stock	23	$ 2,300	$ 7,666.67
Crawford stock	122	13,200	18,857.14
Total		$15,500	$26,523.81

We find that this combination gives us too much market value for M and therefore need to decrease the amount of B stock since it has the higher ratio of market to cost.

3. A second trial which reduces the amount of B stocks might be made with no shares of B stock to M. This gives:

	Shares	*Cost*	*Market*
C stock	155	$15,500	$22,142.86

This produces too little market for M. We now have established an upper and lower limit for the shares of B to be received by M with the range of from 0 to 23 shares. A third trial can be made.

4. If 15 shares of B stock are taken for the third trial, we have:

	Shares	*Cost*	*Market*
B stock	15	$ 1,500	$ 5,000
C stock	140	14,000	30,000
Total		$15,500	$35,000

Since this trial produced a combination which met the necessary conditions, we need only make a "proof" (which would also be desirable if equations were used) of the distribution.

PROOF

Company	*TOTAL* *Shares*	*Value*	*Cost*
Anderson	145	$35,000	$14,500
Bellview	45	15,000	4,500
Crawford	210	30,000	21,000
Total		$80,000	$40,000

Company	*M* *Shares*	*Value*	*Cost*
Anderson	145	$35,000	$14,500
Bellview	15	5,000	1,500
Crawford	140	20,000	14,000
Total		$60,000	$30,000

Company	*N* *Shares*	*Value*	*Cost*
Bellview	30	$10,000	$ 3,000
Crawford	70	10,000	7,000
Total		$20,000	$10,000

Solution 5

Computation of the revenues for the respective billing periods for the customers not billed:

Billing period No. 1—Average bill $5.00	
($13,800 ÷ 2760) 324 × $5.00	$1,620.00
Billing period No. 3—Average bill $4.50	
($14,692.50 ÷ 3265) 335 × $4.50	1,507.50

Total revenues for each billing period:

	No. 1	*No. 3*
Customers billed	$13,800.00	$14,692.50
Customers not billed	1,620.00	1,507.50
Total	$15,420.00	$16,200.00

Ratio of number of days in September subsequent to billing period to days in billing period (30 in all cases):

No. 1—Sept. 6-30......25 days......5/6
No. 3—Sept. 16-30......15 days......3/6 or 1/2

Revenues for periods in September subsequent to billing periods:

No. 1—$15,420.00 × 5/6	$12,850.00
No. 3— 16,200.00 × 1/2	8,100.00

Total unbilled revenue:

	No. 1	*No. 3*
Customers not billed	$ 1,620.00	$1,507.50
Revenues for unbilled portion of September	12,850.00	8,100.00
Total	$14,470.00	$9,607.50

Solution 6

a. June costs:	*Amount*	*%*
Selling price (per unit)	$200	100
Cost of sales (per unit):		
Materials	$ 50	
Labor	30	
Overhead	30	
Total	$110	55
Gross profit	$ 90	45

Revised costs:		
Materials	$ 47.50	(95% of $50)
Labor	36.00	(120% of $30)
Overhead	36.00	(100% of $36)
Total	$119.50	

$119.50 divided by .55 indicates a selling price of $217.00 would be required to maintain a 45 per cent gross profit ratio.

b. June costs:

	Amount	%
Selling price	$200	100
Variable cost	100	50
Fixed cost	10	5
Total	$110	55
Gross profit	90	45

Revised costs:

Materials	$ 47.50
Labor	36.00
Variable overhead	24.00
Fixed overhead	10.00
Total	$117.50

$117.50 divided by .55 indicates a selling price of $214.00.

Solution 7

Computations

Book value of Company B capital stock		$5,894,706
Book value of Company B investment in capital stock of Company C	1,332,794	
Less cost of Company B	687,500	645,294
Adjusted book value of Company B capital stock:		
Total		$6,540,000
Per share		$ 68.125
Book value of Company C capital stock		$2,132,470
Deduct Company B interest		1,332,794
Book value of minority interest		$ 799,676

a. $799,676 ÷ 68.125 = number of shares of Company B to be issued for minority interest in Company C, or 11,738 shares.

b. New percentage of control held by Syndicate A —75,600 ÷ 107,738, or 70.17 per cent.

Accounting Practice—Part II

November 8, 1956; 1:30 to 6 p.m.

Solution 1

RANCO MANUFACTURING COMPANY

Statement of Source and Application of Funds for the Year Ended December 31, 1955

Funds were provided from the following sources:		
Net profit for the year	$213,900	
Add—Transactions not involving an outlay of funds:		
Provision for depreciation	150,600	
Amortization of leasehold improvements	8,100	
Amortization of debenture discount and expense	1,800	
Loss on sale of equipment	11,200	
	$385,600	
Deduct—Realization of deferred income, included in net profit	2,100	$383,500
Sale of equipment		25,000
Decrease in working capital (see schedule)		88,100
Total funds provided		$496,600
Funds were applied to:		
Purchase of marketable securities		$ 98,000
Additional investment in associated company		24,500
Increase in cash surrender value of life insurance		3,700
Additions to fixed assets		197,900
4% convertible debentures paid during year	$ 65,000	
Less—Decrease in debentures payable within one year, included in current liabilities	5,000	60,000
Cash dividend paid		62,500
Settlement of lawsuit charged to retained earnings		50,000
Total funds applied		$496,600

Schedule of Change in Working Capital

Current assets:	*1955*	*1954*	*Increase or (Decrease)*
Cash	$ 63,000	$150,000	$(87,000)
Accounts receivable (net)	85,400	95,000	(9,600)
Inventories	310,000	270,000	40,000
Prepaid expenses	11,000	10,000	1,000
Total	$469,400	$525,000	$(55,600)
Current liabilities:			
Current installments on debentures	$ 60,000	$ 65,000	$ (5,000)
Notes payable to banks	100,000	50,000	50,000
Accounts payable	31,500	42,000	(10,500)
Accrued liabilities	16,800	14,000	2,800
Federal income taxes	58,400	63,200	(4,800)
Total	$266,700	$234,200	$ 32,500
Working capital	$202,700	$290,800	$(88,100)

Comments and Computations

For a simple case such as this no formal working papers are needed. A procedure of running down the accounts and entering each of them in the appropriate section of the "Funds" statement or the "Working Capital" statement is the quickest approach. Schedules for the few accounts requiring analysis can be prepared. This process can be illustrated by the following:

Item	*Amount*	*Disposition*
Cash	$(87,000)	Working capital
Accounts and allowance	(9,600)	Working capital

The receivable and allowance are treated net in the usual statement. Included in "Additional information" are the amounts of accounts charged against the allowance. This has no effect on the statements since it is already reflected in a reduction of the 12/31/55 balance of the allowance, and a line may be drawn through it.

Inventories	$40,000	Working capital
Prepaid expenses	1,000	Working capital
Cash surrender value of life insurance	3,700	Required funds (Working capital)
Unamortized debt discount	(1,800)	Add back to profit

The amortization was a charge against income, but since it did not require working capital it is a "non-cash" charge and is added back to book profit.

Marketable securities	98,000	Required funds

This is non-current because it has been set aside for use in adding to fixed assets.

Stock of associated company	24,500	Required funds
Machinery and equipment and allowance for depreciation	11,100	

This requires analysis using the data presented at the end of the problem. The analysis shows the following:

Machinery and equipment

Balance 1/1/54	$743,800	Balance 1/1/55 (Per ledger)	$823,200
1955 purchase	197,900	Cost of asset retired (computed)	118,500
Total	941,700		941,700

Allowance for depreciation

Charge for asset retired— ($118,500 less 36,200 as given)	$ 82,300	Balance 1/1/54	$310,400
Balance 12/31/55	378,700	Provision (computed)	150,600
Total	461,000		461,000

The cash received from sale of the asset is preferably considered a source of funds rather than an offset to the purchases of equipment. Therefore, working from the analyses given above, we have:

Depreciation (A non-cash charge made against income)	$ 150,600	Add back to profit
Assets purchased	197,900	Required funds
Retirement of asset:		
Cash received	25,000	Provided funds
Loss charged against income	11,200	Add back to profit
Leasehold improvements (net)	(8,100)	Add back to profit

The amortization of improvements has been charged against income but did not require working capital and, therefore, must be added back to profit to determine the amount which operations added to working capital.

Notes payable to banks	$ 50,000	Working capital
Accounts payable	(10,500)	Working capital
Accrued liabilities	2,800	Working capital
Federal taxes accrued	(4,800)	Working capital
Deferred income	(2,100)	Deduct from profit

Profit was increased by the net decrease in deferred income but this did not add to working capital because the account is in the non-current classification.

4% debentures	$ (60,000)	Required working capital

The amount transferred from the non-current to the current classification results in decreasing working capital.

4% debentures (current)	$ (5,000)	Working capital
See above as to the $60,000.		
Common stock	250,000	No effect
This represented the amount transferred within non-current accounts (from retained earnings to common stock) and has no effect on working capital.		
Retained earnings	178,200	No effect
The change can be analyzed as consisting of closing 12/31/54 cash dividend of $50,000 and 12/31/54 net profit to the opening balance. Neither entry affects working capital.		
Net profit (1955)	213,900	Provides funds
Dividend paid in stock—See common stock		
Dividend paid in cash—1955	(62,500)	Required funds
Settlement of lawsuit	(50,000)	Required funds

This settlement decreased working capital and since it has not been charged against income, it should be treated as a separate item.

Solution 2

a. To determine the inventory at July 15, 1956, the gross profit method must be used. Figures from the previous year show the following:

Cost of goods sold:			
Inventory January 1, 1955			$155,000
Add:			
Purchases	$280,000		
Less purchase discounts	8,000		
	$272,000		
Freight—in	18,000	$290,000	
Direct labor		120,000	
Factory expenses:			
Depreciation—Machinery and equipment	5,000		
Factory supplies	2,500		
Miscellaneous manufacturing expenses	6,300		
Small tools	2,000		
Payroll taxes	2,200	18,000	428,000
Total			583,000
Inventory December 31, 1955			165,000
Cost of goods sold			$418,000
Sales		$500,000	
Sales returns		25,000	$475,000
Per cent of cost of goods sold to sales			88%

Computation as of July 15, 1956

Inventory January 1, 1956			$165,000
Purchases	$126,500		
Less purchase discounts	6,000		
	$120,500		
Freight—in	6,400	$126,900	
Direct labor		111,000	
Factory expenses:			
Depreciation—Machinery and equipment	$ 3,000		
Factory supplies	200		
Miscellaneous manufacturing expenses	1,200		
Small tools	1,500		
Payroll taxes	1,650	7,550	$245,450
Total goods available			$410,450
Cost of sales, 88% of $263,000, consisting of sales less returns and allowances			231,440
Computed total inventory			$179,010
Less merchandise in transit			4,010
Total merchandise on hand			$175,000

b. Insurance recovery

Loss ($175,000 less $85,000)	$ 90,000
Insurance required under "co-insurance" 80% of $175,000 or	140,000
Insurance carried	120,000
Amount recoverable	
$\frac{\$120{,}000}{140{,}000} \times \$90{,}000$ loss	77,143

Solution 3

a.

INCREDIBLE GADGET CORP.

Cost Statement—May, 1956

	Unit	Amount	Per unit
Machining Department			
Materials	75,000	$120,000	$1.60
Labor	65,000	87,100	1.34
Overhead	65,000	39,000	.60
Total		$246,100	$3.54
Transferred to finishing	60,000	212,400	3.54
Work-in-process inventory		$ 33,700	
Assembly and Finishing Department			
Transferred from Machining	60,000	$212,400	$3.54
Materials	59,500	41,650	.70
Labor	56,500	101,700	1.80
Total exclusive of overhead		$355,750	$6.04
Overhead:			
Expenses		$ 56,810	
Cost of spoiled units:			
Transferred cost	1,000	$ 3,540	
Materials	500	350	
Labor	500	900	
Overhead to be assigned	56,000	$ 61,600	$1.10
Total cost		$412,560	$7.14
Transferred to finished goods	50,000	357,000	7.14
Work-in-process inventory		$ 55,560	

Note: The method to be followed for cost of spoilage is specified. It charges all spoilage cost to completed units.

b.

Details of Work-in-Process Inventories

	Units	Per unit	Amount
Machining Department			
Materials	15,000	$1.60	$24,000
Labor	5,000	1.34	6.700
Overhead	5,000	.60	3,000
Total			$33,700
Assembly and Finishing Department			
Transferred cost	9,000	$3.54	$31,860
Materials	9,000	.70	6,300
Labor	6,000	1.80	10,800
Overhead	6,000	1.10	6,600
Total			$55,560

Solution 4

a. *Straight-line:* Under this method, the cost or other basis of the property, less its estimated salvage value, is deducted in equal annual installments over the period of its estimated useful life.

Sum-of-the-years' digits: The annual depreciation deduction is computed by applying a changing fraction to the taxpayer's cost of the property reduced by the estimated salvage value. In the fraction used for any year, the numerator is the number of remaining years of the estimated useful life of the property, and the denominator is the sum of the numbers representing the years of life of the property.

Declining-balance: A uniform rate is applied to the unrecovered basis of the property. Since the basis is always reduced by the prior years' depreciation in the property, the rate is applied to a constantly declining balance. The salvage value is not deducted from the basis prior to applying the rate. For federal income tax purposes, this method may be used with a rate of depreciation not exceeding twice the straight-line rate.

b. Summary of Property and Depreciation:

PROPERTY

Year Ended December 31	*Balance First of Year*	*Additions*	*Dispositions*	*Balance End of Year*
1955	—	$50,000	—	$50,000
1956	$50,000	20,000	$7,000	63,000

ALLOWANCE FOR DEPRECIATION

Year Ended December 31	*Balance First of Year*	*Provision During Year*	*Dispositions*	*Balance End of Year*
		Straight-Line		
1955	—	$2,500	—	$ 2,500
1956	$ 2,500	6,000	$1,050	7,450
		Sum-of-the-Years' Digits		
1955	—	$ 4,545.45	—	$ 4,545.45
1956	$ 4,545.45	10,454.54	$1,845.45	13,154.54
		Declining Balance		
1955	—	$ 5,000	—	$ 5,000
1956	$ 5,000	11,000	$1,960	14,040

COMPUTATIONS

Straight-Line:

1955 On additions of $50,000 @ ½ of 10% rate—		$2,500
1956 On opening balance of $50,000 @ 10% rate—	$5,000	
On additions of $20,000 @ ½ of 10% rate—	1,000	
Total provision 1956	$6,000	

Accumulated on 1956 retirement of $7,000 for ½ of 1955 and all of 1956 (15% in total)—$1,050

Sum-of-the-Years' Digits

Sum of digits 1 through 10 equals 55		
1955 for ½ of 10/55th of additions	$4,545.45	
1956 for first half of year (½ of 10/55ths)		$ 4,545.45
for second half of year (½ of 9/55ths)		4,090.91
for ½ of 10/55ths of additions of $20,000		1,818.18
Total provision 1956		$10,454.54
Accumulated on 1956 retirement of $7,000: 14.5/55ths (5 + 5 + 4.5) of $7,000—	$1,845.45	

Declining Balance:

1955 On additions of $50,000 @ ½ of 20% rate—		$5,000
1956 On net undepreciated balance at first of year of $45,000 @ 20% rate		$ 9,000
On additions of $20,000 @ ½ of 20% rate—		2,000
Total provision 1956		$11,000
Accumulated on 1956 retirement of $7,000:		
In 1955 (½ of 20%)	$ 700	
In 1956 (20% of $6,300 balance)	1,260	
Total	$1,960	

Solution 5

A AND B COMPANY
Balance Sheet, March 31, 1956

A COMPANY
Balance Sheet, April 1, 1956

Assets	*A and B Company March 31, 1956*	*A Company April 1, 1956*
Current Assets:		
Cash	$ 7,100	$ 7,100
Notes receivable	5,650	
Accounts receivable	8,200	8,200
Inventory	31,200	31,200
Total current assets	$52,150	$46,500
Property:		
Land	$ 250	$ 250
Buildings	2,000	2,000
Machinery and equipment	5,000	5,000
Truck	1,200	1,200
Total	$ 8,450	$ 8,450
Less allowance for depreciation	2,250	2,250
Net property	$ 6,200	$ 6,200
Total	$58,350	$52,700
Liabilities		
Current Liabilities:		
5% note payable due October 1, 1956		$ 3,000
Accounts payable	$17,000	18,400
Total current liabilities	$17,000	21,400
Long-term Debt—5% notes maturing $3,000 annually beginning October 1, 1957		$ 9,000
Capital:		
A	$22,300	$22,300
B	19,050	
Total capital	$41,350	$22,300
Total	$58,350	$52,700

A AND B COMPANY
Worksheet, March 31, 1956
(Not Required)

	Trial Balance Debit	*Trial Balance* Credit	*Adjusting Entries* Debit	*Adjusting Entries* Credit	*Profit and Loss* Debit	*Profit and Loss* Credit	*Balance Sheet* Debit	*Balance Sheet* Credit
Cash	$ 7,100						$ 7,100	
Accounts receivable	12,050		(1) $ 2,850	(2) $ 1,050			8,200	
				(3) 5,650				
Notes receivable			(3) 5,650				5,650	
Merchandise	22,500			(4) 22,500				
Inventory			(4) 22,500				31,200	
			(5) 8,700					
Sales				(4) 39,600		$39,600		
Cost of sales			(4) 38,400	(5) 8,700	$29,100			
				(6) 600				
Property	7,250			(7) 7,250				
Land			(7) 250				250	
Buildings			(7) 2,000				2,000	
Machinery and equipment			(7) 5,000				5,000	
Truck			(4) 1,200				1,200	
Expense	6,550		(9) 250		6,800			
Accounts payable		$17,600	(6) 600					$17,000
Allowance for depreciation				(8) 2,000				
				(9) 250				2,250
Capital—A		20,550	(2) 525	(1) 1,425		1,850		22,300
			(8) 1,000					
Capital—B		17,300	(2) 525	(1) 1,425		1,850		19,050
			(8) 1,000					
Total	$55,450	$55,450	$90,450	$90,450	$ —	$ —	$60,600	$60,600

Journal Entries to Record Withdrawal of B

B capital	$19,050	
Note to B—current		3,000
Notes to B—non-current		9,000
Notes receivable		5,650
Account payable to B		1,400

Auditing

November 8, 1956; 9 a.m. to 12:30 p.m.

Solution 1

The following reconciliation shows the flow of materials and reconciles the accounting and factory records.

DEPARTMENT M STOCKROOM
Reconciliation and Analysis of Receipts and Withdrawals

	Initial Inventory	*Receipts*	*Withdrawals*	*Final Inventory*
Per accounting department	$11,300	$14,000	$(13,000)	$12,300
Receipts properly entered by factory, but incorrectly entered by accounting department as stockroom N		240		240
Correction by accounting department of error of prior period. $800 withdrawal had been entered as $500. Correction of $300 entered in current period	(300)		300	
Shortage of item M-143 entered in factory records but not entered by accounting department			(45)	(45)
Per factory	$11,000	$14,240	$(12,745)	$12,495

Solution 2

a. Assignment of functions
Employee No. 1:
(1) Maintain general ledger
(2) Reconcile bank account
(3) Issue credits on returns and allowances
Employee No. 2:
(1) Prepare checks for signature
(2) Cash receipts
(3) Maintain disbursements journal
Employee No. 3:
(1) Maintain accounts payable ledger
(2) Maintain accounts receivable ledger

b. Undesirable combinations are as follows:
(1) Cash receipts and accounts receivable
(2) Cash receipts and credits on returns and allowances
(3) Cash disbursements and accounts payable
(4) Cash receipts and bank reconciliation
(5) General ledger and cash receipts
(6) Accounts receivable and credits on returns and allowances

Solution 3

Comment: The desirability of setting up donated assets on the books is somewhat controversial in many instances. Also there may sometimes be no reasonable basis for determining the value to the company of such assets. However, in this case the fact that here the company has met the provisions of the agreement for four years and intends to continue to do so, and the fact that the $1,000,000 was "cost" to the city at the time of the donation, reduces the questionable features of having the asset valued at $1,000,000. Even if there were serious doubts as to the propriety of having the asset recorded, the auditing procedures would still be about the same as those listed below.

Audit program for donated assets and allowance for depreciation:

(1) Prepare separate schedules for "Contingent Asset—Land," "Contingent Asset—Buildings," "Buildings," "Depreciation on Contingent Asset—Buildings," and "Depreciation on Buildings."
(2) Examine the contract and correspondence between Grand City and the client. Determine the exact conditions to be met by the client in order to get title to the property.
(3) Determine whether the client has to date complied with all of the conditions necessary to getting legal title to the donated property.
(4) Obtain proper authorizations for original capitalization of the donated property.
(5) Verify the cost of the property to Grand City by checking city records. This valuation would presumably be the most acceptable basis for capitalization by the company.
(6) Examine the minutes of meetings of the board of directors and of special committees for evidence that the corporation might not intend to meet the conditions necessary to obtain title to the donated property.
(7) Ascertain that the buildings are now occupied by the client.
(8) Vouch all charges and credits to the accounts.
(9) Determine the amount of any liens or assessments.
(10) Examine public records to verify the holder of the legal title.
(11) Determine whether any buildings have been bought or sold, or otherwise disposed of, and compute the gain or loss if applicable.
(12) Investigate insurance for adequate coverage.
(13) Verify depreciation rates, calculations and allowances. If the company intends to obtain title to the property in 1962, adjustments are necessary to spread the cost of the donated buildings over their estimated lifetime.

(14) Determine whether, at the time of the donation of the property, the credit had been to an account such as Contingent Paid-in Surplus—Plant Donation. No debit should be made to this account until the company has been given legal title to the property.

Solution 4

a. The audit should include the following steps:
(1) Prepare a schedule by machines showing cost, depreciation, rentals received, rental income and deferred rental income by months.
(2) Trace information in detailed plant ledger of leased machines to leases for all machines leased during the current year. Test as to date of lease, amount of rental and machine serial number.
(3) Test the cost of the machines by footing and price-testing the client's underlying labor, burden and material costs. Base the amount of test on the degree of internal control.
(4) Ascertain that the inventory of machines was properly relieved of all of the costs of the machines transferred to fixed assets during the current year.
(5) Test rentals received per leased machines ledger and trace the recorded payments into the cash receipts record.
(6) Prepare and mail confirmations to the lessees of the machines. Confirm all leases at least every two years by positive confirmation letters.
(7) Prepare a summary of the lease agreement for the permanent file. Review this summary each year for necessary changes.
(8) In case a machine is sold, test the entry removing it from fixed assets and charging it to cost of sales. Test reserve for depreciation, rental income account and profit on sale of fixed asset.

b. The leased machines should be carried on the balance sheet as a fixed asset at cost and the depreciation should be based on cost less the salvage value.

c. The rental income should be taken into rental income on the accrual basis and prepayments should be handled as deferred rental income. In the income statement the rental income earned and the related costs should probably be shown as identifiable items making up part of gross income and costs because the importance of this source of income will grow each year if the company continues its present policy. If the policy is not to be continued, the item is probably of minor significance and could be treated as "other" income (and deductions).

Solution 5

The accounts needed to provide control over budget operations through the general accounting system are the following:

Estimated Revenues. This account is debited at the beginning of the period with the budget estimate of revenues for the fund for the ensuing fiscal period. Subsequent changes in these estimates are debited or credited to the account.

As revenues are realized, either through the setting up of Accounts receivable or through collection, Revenues account is credited.

At the end of the fiscal period, Revenues account is closed to Estimated Revenues, and the latter to Unappropriated Surplus.

If a governmental unit wishes to keep the number of its accounts to a minimum, the accounts of Estimated Revenues and Revenues may be combined in the former, in which case the credits to Estimated Revenues represent the revenues of the fund for the fiscal period.

Appropriations. The Appropriations account is credited at the beginning of the fiscal period with the amount appropriated for various purposes in the budget and payable out of the fund. Subsequent credits or debits consist of additional appropriations or adjustments in appropriations and of other items which increase the amount available for expenditure.

As expenditures are made, they are debited to Expenditures account in the General ledger, and to subsidiary detail accounts.

At the end of the fiscal period, Expenditures account is closed to Appropriations, which ordinarily is then closed to Unappropriated Surplus, except as to an amount equal to the balance of Appropriation Encumbrances. The latter amount is carried forward to cover unliquidated encumbrances, definite invoices (or vouchers) which will be presented for payment at a later time.

If a governmental unit wishes to keep the number of its accounts to a minimum, the Appropriations account and the Expenditures account may be combined in the former, in which case the debits to Appropriations account represent the expenditures of the fund for the fiscal period.

Encumbrances. Encumbrances consist of those obligations of a fund which are represented by outstanding orders, contracts or similar items which are expected to become payable, and for which provision must therefore be made. In order to exhibit properly the condition of a fund, it is necessary to show what amount is outstanding in this form. For this purpose, accounts should be kept which will show this information. These accounts consist, in the case of revenue funds, of Appropriation Encumbrances account and Reserve for Encumbrances account. (The latter account is sometimes called Unliquidated Encumbrances.) The *estimated* costs of all items for which commitments are made, and which later will be presented in the form of vouchers to be charged to Expenditures account, are debited to Appropriation Encumbrances and credited to Reserve for Encumbrances. When the items are audited for payment, the reverse entry is made in the encumbrance accounts, debits for actual amounts of vouchers being made at the same time in Expenditures account.

The balance of Appropriation Encumbrances account, therefore, shows at any time the amount of unliquidated encumbrances outstanding against appropriations of the fund. This sum is to be deducted from the *unexpended* balance of Appropriations (Appropriations less Expenditures) account, and the net difference will be the *unencumbered* balance of Appropriations.

The balance of Reserve for Encumbrances shows the amount outstanding in the form of orders, contracts and similar items, at their estimated costs, and will appear as one of the obligations of the fund in its balance sheet.

Solution 6

Comment: Information as to how the company relieves cost for partial deliveries is not given. Presumably, credits to cost might be made on the basis of the figures used in estimating for each job. If that procedure is used, a problem is created because of the possibility that actual costs may vary widely from estimated. "Start-up" costs may not be absorbed on newly started jobs and determining a reasonable valuation for work in process is extremely difficult. Bills of material, cost estimates, time studies and production planning records would all be helpful to the auditor in establishing an amount for the work-in-process inventory. The following suggestion of procedures for work in process can be considered as appropriate in the usual situation such as that described but might have to be modified as the audit progressed. No program is given for materials since they are not significant.

(1) Review the system of internal control to determine the nature and extent of inventory tests needed.
(2) Prior to March 31, 1956, discuss with management the physical stock taking to be made as of that date and ascertain the methods to be followed as to:
   (a) Forms to be used in recording the original count and control to be maintained over them.
   (b) Instructions to personnel to be used with regard to completion of forms and stressing individual responsibility. (Nature of business will require personnel with technical knowledge to determine percentage of completion of work in process.)
(3) During the inventory taking, observe the procedure and make test counts. (The main purpose is to test for material existence since it will be necessary to rely on management for machining operations completed.) Trace items to final inventory summary and account for any large discrepancies.
(4) Obtain original stock sheets. Test the final inventory sheets by comparison with the originals and with tickets, cards or other means used in recording the original count.
(5) See that inventory sheets are signed or initialed by persons responsible for taking the stock, determining the prices and making the calculations and footings. Obtain from a responsible official a clear and detailed statement in writing as to the method followed in taking stock and pricing it and as to the quantity, quality, and condition and the accuracy of the inventory as a whole.
(6) Test the accuracy of the footings and extensions, especially of the larger items.
(7) Make a test comparison of the physical inventory with the job cost records. Any major discrepancies should be investigated. Review the job orders for the period, and account for all numbers.

(8) Since the cost system is not adequately controlled by the financial accounting records, special attention is required. There is always a possibility that orders may have been completed, billed and shipped but not have been taken out of work-in-process records. Compare sales for the months preceding the close of the fiscal period with the job cost records to see that goods which have been shipped are not erroneously included in inventory records.

(9) Note goods ready for shipment and determine that where the title has passed to customers, the goods have not been included in the inventory.

(10) Determine that goods which are not owned but are on consignment from others or were supplied by customers have not been included in inventory. Confirm the liability for materials and tooling from customers.

(11) Inquire and make tests to determine that no machinery or other material which has been charged to plant or property account is included in the inventory.

(12) Make inquiries and tests to ascertain that purchase invoices for stock included in the inventory have been entered on the books. Look for postdated invoices and give special attention to goods in transit.

(13) If it is customary to receive partial deliveries under purchase contracts which are not promptly billed, confirm the quantities delivered by communication with the vendors.

(14) Tests of cost records should be made as follows:

(a) Raw material cost charged to work in process should be traced on a test basis to stores records, purchase invoices and current price listings.

(b) Direct labor costs should be computed based on rates applicable to classification as tool and die or production workers. Where work is fairly well intermingled an average hour per shop may be used. Trace to job classification, payroll records and other supporting data.

(c) Determine that factory overhead has been properly allocated to the major classes of work in process: namely, special machines; tools, dies and fixtures; and production. Special emphasis should be given to allocation of indirect labor, depreciation, insurance and indirect materials. (See that no selling expenses, interest charges or administrative expenses are included in factory overhead costs except in so far as administrative expenses apply to production. Interdepartmental profit and in cases of consolidated statements intercompany profit are to be eliminated from the inventories.)

(15) Ascertain that inventories are stated at cost or market, whichever is lower, or determine that any other basis which has been adopted is in accordance with sound accounting practice in the trade. Trade discounts are to be deducted in determining inventory costs. Cash discounts may or may not be deducted, depending upon the practice of the trade and of the company.

(a) Replacement costs should be considered and also selling prices, less shipping and selling expenses. (The nature of labor disputes and sudden market increases should be taken into consideration since most tool and die work is taken based on quoted prices and work in process may extend for a period of a few months to a year or more.)

(b) In the case of partial shipments or uncompleted contracts determine the basis for billing by reference to customer purchase orders. If it is apparent that there will be a loss on the completed contract, provision should be made for the estimated loss.

(16) Give consideration to the possibility that excessive or damaged stock may be included in the inventories at greater than realizable value.

(17) Inquire about returns made under guarantees and any goods received to be repaired. Determine that any such goods are not included in the inventory.

(18) Advance payments on account of purchase contracts for future delivery preferably should be shown in the balance sheet under a separate heading.

Solution 7

Customer's Account

a. Since the generally accepted auditing requirement of obtaining confirmation of receivable balances cannot be met as to this customer with the very large balance, alternative auditing procedures must be adopted. These would include ascertainment of the subsequent collection of the balance by examining the remittances or the notices accompanying the remittances and identifying them with amounts included in the customer's December 31, 1955 balance. (It is not considered sufficient to refer merely to the cash receipts book of the subsequent period to support cash credits to the account, since such credits may be fictitious or improperly applied to the account being examined.) To the extent that the outstanding balance has not been collected or the collections cannot be identified with components of the balance, shipping records and copies of sales invoices should be examined to support the charges to the customer's account.

Frequently where a customer indicates an inability to confirm a total balance, it is still possible to obtain from him confirmation of specific unpaid invoices or confirmation of specific payments. However, if it is concluded that the customer can, under no circumstances, confirm his balance, these cannot be considered as acceptable alternative audit procedures in this instance.

b. The mere failure of the customer to confirm his account balance would require no disclosure in the financial statements or footnotes thereto, since the absence of confirmation, of itself, is no indication that the balance is not properly stated.

c. The auditor's inability to obtain confirmation of so substantial a receivable balance (as required to conform to generally accepted auditing standards) should be mentioned in his short-form report. Since, as assumed in this question, the auditor is able to satisfy himself of the propriety of the receivable balance by means of the alternative audit procedure described above, he obviously need not qualify his opinion as to the financial statements. At the same time, however, his examination was not made in accordance with generally accepted auditing standards to the extent that he did not obtain sufficient confirmation of receivable balances. As a consequence, he should, without qualifying his opinion, state that his 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 he considered necessary in the circumstances, except that it was not practicable to obtain confirmation of a large receivable balance from a customer but that he satisfied himself as to the propriety of such balance by means of other auditing procedures.

Inventory in Warehouse

a. Generally accepted auditing standards require tests of inventory quantities where inventories are an important factor in the determination of a company's financial position or its results of operations. Where inventories are held in public warehouses, compliance with this requirement is usually met by obtaining confirmations from the custodians of the quantities held by them and, where the amounts of such inventories are relatively large, by investigating the credit standings of the custodians. In the illustration given in this question, the auditor should obtain confirmation of the quantities held in the public warehouses and, at least as to the one warehouse in the distant city, should satisfy himself as to the existence of the warehouse and its credit standing by reference to the Dun & Bradstreet service or by correspondence with the Chamber of Commerce, Better Business Bureau, or similar organization in the city in which the warehouse is located.

b. In the absence of any doubt as to the existence or security of inventories, there is no reason for disclosing their location in the financial statements or footnotes thereto. The physical location of inventories normally should not affect the fairness of their presentation in the financial statements. Consequently, on the basis of the assumptions stated in this question, no disclosure in the financial statements or related footnotes would be required.

c. The auditor normally need give no recognition in his short-form report to the mere fact that a portion or all of the company's inventory is located in public warehouses. His investigation of the existence and credit standing of the warehouse and his obtaining of confirmations of quantities comply with generally accepted auditing standards and presumably should satisfy him as to the fairness of the stated inventory quantities, thus obviating the necessity of qualifying his opinion.

Patent Infringement Suit

a. The only additional audit procedure to be followed is to obtain immediately prior to the rendition of the short-form report, a confirmation from the company's chief executive officer or its counsel that the status of the litigation has remained unchanged. This preferably should be in writing.

b. The existence of a contingent liability of this magnitude must be disclosed in a footnote to both the balance sheet and statement of income and earned surplus and preferably should be referred to in the earned surplus captions on both these statements. Such disclosure is necessary to provide the reader of the financial statements with all the pertinent information required for a sound and judicial appraisal of the company's financial position and results of operations. (Obviously, since, in the opinion of counsel for the company, judgment will be in favor of the company, no provision for possible loss should be reflected in the financial statements.)

c. Inasmuch as the contingent liability is fully described in a footnote to the financial statements, it need not be mentioned in the short-form report. As to this item, the examination was made in accordance with generally accepted auditing standards and the financial statements, with their footnotes, adequately disclose the contingent liability. Accordingly, there is no reason to qualify either the conformity of the scope of the examination with generally accepted auditing standards or the opinion that the financial statements (which include their footnotes) present fairly the company's financial position and its results of operations.

Change in Accounting for Research Expenditures

a. No additional audit procedures would be required merely as a result of the company's changing its accounting classification for expenditures for research. The normal audit program would presumably include procedures for the adequate testing of transactions as to their validity and propriety of accounting distribution. These procedures should serve equally well, whether the items in question have been capitalized or expensed.

b. Disclosure of the change in the company's practice of accounting for these expenditures (which are material in amount in relation to the company's operations) would be required in a footnote to the statement of income and retained earnings and, if the financial position is materially different than it would have been had the change not been made, in a footnote to the balance sheet. The footnote should include a general description of the nature of the change (such as the description included in this question) and the effect which such change has had on the reported net income and, if sufficiently material, its effect on the retained earnings balance. If the statement of income and retained earnings is presented with comparative figures for the preceding year, it would be preferable, in disclosing the effect of the change on net income, to state in the footnote the amount by which the previous year's net income would have been different had the company's current practice been in effect during the preceding year. In the absence of comparative statements, it is customary to state in the footnote the amount by which the current year's net income would have differed had the change not been made.

c. Since the examination of these expenditures included appropriate tests of the accounting records and such other auditing procedures as were considered necessary, there would be no occasion for qualifying the conformity of the scope of the examination with generally accepted auditing standards. Similarly, inasmuch as the company's present practice was adopted as a result of a previous recommendation, it must be presumed that the accounting for these expenditures is in conformity with generally accepted accounting principles and consequently no qualification of the opinion is needed in this respect. At the same time, however, the financial statements have not been prepared in conformity with accounting principles applied on a basis consistent with that of the preceding year, to the extent that the company's practice relating to the accounting for these expenditures was changed. The standard accountants' short-form report customarily states the consistency or lack thereof of the statement presentation with that for the preceding year, at least in those instances where the accountant has examined the accounts for such preceding year. Accordingly, in these circumstances, the auditor should state that, in his opinion, the financial statements present fairly the company's financial position and results of operations in conformity with generally accepted accounting principles applied (except for the change in accounting for expenditures for research, as explained in Note . . . to the financial statements) on a basis consistent with that of the preceding year. Occasionally, the certifying accountant will state that he approves of the change in practice but such statement is not considered necessary since his failure to take exception to the conformity of such practice with generally accepted accounting principles can properly be interpreted as approval of the practice.

Solution 8

(1) Examine charter and by-laws.

(2) Review minutes of meetings of board of directors and stockholders.

(3) Review generally with company personnel the past financial history.

(4) Review file of open contracts and commitments.

(5) Inquire about the degree of internal control.

(6) Scan the general ledger noting the accounts included and items which seem to be unusual.

(7) Ascertain that bank accounts have been reconciled on a current basis. Review latest reconcilements for unusual reconciling items.

(8) Review notes and accounts receivable for collectibility. Scan subsequent cash collections. Review control accounts subsequent to balance-sheet date for large credits other than from the cash receipts book.

(9) Ascertain that the basis of pricing inventory is in accordance with generally accepted practice. If at the lower of cost or market inquire as to how market was determined and what steps were taken to see that market was not exceeded. Consider the reasonableness of the balance in view of all relevant circumstances.

(10) Determine the nature of the sundry investments. If appropriate, examine the documents and review income accounts for related income.

(11) Ascertain by inquiry if the carrying value of plant property represents anything other than cost and, if so, investigate. Inquire when the last physical inventory of equipment was taken, if any. Review the depreciation records to see that depreciation has been provided on a reasonable and consistent basis. Inquire about any differences that may exist between book and tax depreciation.

(12) Review deferred charges, for reasonableness.

(13) Review accounts payable trial balance for old or unusual balances. Ascertain if vendors' statements are being reconciled on a current basis. Review subsequent records to determine if any unusually large items were passed which should have been recorded prior to the balance-sheet date.

(14) Review the status of prior years' federal taxes on income and determine

the years subject to examination by the Treasury Department. Review prior Revenue Agent's reports, if any, to determine the nature and amount of adjustments. Make note of any unused tax benefits available to the taxpayer. After reviewing the prior years' tax status, determine the adequacy of the current balance in the liability account. Ascertain if any of the new alternative procedures permitted by the 1954 Internal Revenue Code, such as declining-balance depreciation, etc., were used for book or tax purposes. If used, calculate effect. Review status of state taxes.

(15) Review accrued liabilities for general reasonableness. Ascertain that employee taxes have been properly paid on a current basis. Inquire about any change in state employee withholding tax rates or otherwise which may have a material effect on subsequent accounting periods.

(16) Determine the nature and correctness of funded debt. Read indenture for special restrictive provisions, if any, funding and repayment requirements. Ascertain that company appears to be in compliance with terms.

(17) Review preferred and common stock certificate books. Ascertain provisions of preferred stock issue, including voting and special liquidation rights. Ascertain if any preferred dividends are in arrears. Determine basis of carrying value of both classes of stock. If not voluminous, prepare a list of holders of the outstanding capital stock.

(18) If practical, review the surplus account from inception of the company.

(19) Review the various elements of income and expense and compare with prior periods. Determine reasons for significant fluctuations in important ratios. Scan individual expense accounts for unusual items. Review back-order file, if any, and review the current tempo of sales activity, and consider the soundness thereof. Review individual product cost developments and gross profit ratios, if available.

(20) Obtain an opinion (preferably in writing) from responsible officials of the X.Y.Z. Mfg. Corp. with respect to liabilities of the company.

(21) Consider the effect of any unusual significant events since the date of the last statement.

Commercial Law

November 9, 1956; 9 a.m. to 12:30 p.m.

Solution 1

a. (1) No. Guaranteeing payment of the obligations of others is not a normal function of the partnership's business and the sole action of Bivins does not bind the firm. While every partner is an agent of the partnership for the purpose of its business, an act of a partner which is not apparently for the carrying on of the partnership business in the usual way does not bind the partnership unless authorized by the other partners.

(2) Yes. Engaging such employees and agents as are necessary is a normal function in the ordinary and usual business of the partnership.

b. All the remaining debts. Under subsection (b), Section 15 of the *Uniform Partnership Act* partners are jointly liable for all partnership debts. Hence each one can be held liable for the whole amount.

c. He would have no liability for such remaining debts and could not be required to pay them. Under Section 7 of the *Uniform Limited Partnership Act* a limited partner is not liable to creditors as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business.

d. (1) Section 18 of the *Uniform Partnership Act* provides that, subject to any agreement between the partners, no person can become a member of a partnership without the consent of all the partners.

(2) Brady can be admitted over Snyder's opposition as the *Act's* provision requiring consent of all partners is subject to any agreement the partners may have. In this case there is such an agreement under which the consent of only three partners is required and such consent exists.

Solution 2

a. Title to the tubing passed to B when the tubing was delivered to the carrier. When unascertained goods are purchased by description, title passes when the goods are unconditionally appropriated to the contract. Where the terms are F.O.B. shipping point, delivery to the carrier at the shipping point is the unconditional appropriation.

b. B had the risk of loss while the goods were in transit. The owner of the goods has the risk of loss. As explained above, B was the owner while the goods were in transit.

c. The C.O.D. term had no effect on the passage of title. The ordinary presumption of the passage of title on delivery of the goods to the carrier applies. The only effect of the C.O.D. term is a reservation in the seller of a right to possession until the price has been paid.

Solution 3

a. The following obligations are common to all bailments: On the part of the bailor, to deliver a safe chattel. On the part of the bailee (1) to fulfill the purpose of the bailment, (2) to protect the chattel, and (3) to return it.

b. A pledge is a deposit of personal property, without transfer of title, as security for some debt or engagement.

c. (1) Yes. Pawnbrokers are prohibited from selling pledges unless there is default and then only in a manner specified by law. Therefore, on redemption, they must return the identical item.

(2) No, as to the identical certificates; yes, as to securities of same kind and total face value. Stockbrokers are ordinarily authorized by law to sell or repledge securities deposited with them to secure advances they may make. Therefore, they are not required to return the identical securities on redemption but must keep on hand at all times for that purpose an equivalent amount of the same securities.

d. The bailor impliedly warrants that the article hired is fit for the purpose for which it is hired. The bailee may recover damages resulting from the breach.

e. Four exceptions or limitations are (1) acts of God, (2) acts of the public enemy, (3) losses directly attributable to carelessness or negligence of the guests, and (4) statutory limitations.

Solution 4

a. An agency may be created by acts of the parties. In addition to "by appointment" (that is, by contract) an agency may be created by ratification. Also, an agency may be created by operation of law. Two ways are (1) by estoppel (acts of the principal because of which he may not deny the relationship), (2) by necessity (example: husband bound by his wife's purchase of necessities).

b. "Attorney in fact" is a term applied particularly to agents whose authority is conferred by a written instrument such as a power of attorney.

c. A person is disqualified to act as an agent when he (1) has a personal interest adverse to that of the principal, (2) acts for several principals whose interests are conflicting, and (3) and a third party have mutual interests that could conflict with his principal's. A special case exists where the party does not have qualifications or licenses necessary under the law, as required for lawyers, auctioneers, brokers, etc.

d. Yes. Such approval (ratification) must be of something the principal could do lawfully, the principal must have competence to ratify, the act approved must have been done in the name and on behalf of the person ratifying, the ratification must be with knowledge of all the facts, and the ratification must cover the complete act.

Solution 5

A's contention that delivery by September 5 was a condition of the contract is correct, and, in the absence of special circumstances, the Boston Company could refuse to accept the report or to pay for it. But, while C's failure to meet the essential time requirement would normally constitute a breach of contract, the lack of co-operation by the Boston Company's staff so hindered C as to prevent his compliance with this condition. Such hindrance therefore relieves C from compliance with the time requirement, there is consequently no breach of contract by him, the Boston Company is not discharged from its contractual obligation to accept any pay, and C can collect his full fee.

"If a promisor prevents or hinders the occurrence of a condition, or the performance of a return promise, and the condition would have occurred or the performance of the return promise been rendered except for such prevention or hindrance, the condition is excused, * * * *." (Restatement of the Law of Contracts, Sec. 295.)

Hence C's right to collect does not rest upon a claim of substantial performance, or of unjust enrichment of the Boston Company but upon his full performance. Nor is the doctrine of impossibility of performance involved. The subject matter of the contract did not become illegal or impossible to perform.

Solution 6

a. (1) Disability of a plaintiff to sue, due to infancy, insanity, etc., and (2) absence of a defendant from the jurisdiction so that he is not subject to legal process. In (1) it would be unjust to let time run against one unable to sue and in (2) it would be unjust to let time run in favor of one who has placed himself in a position where he cannot be sued.

b. Two ways of tolling the statute are (1) a clear acknowledgement of the debt and (2) a payment on account. In (1) there is an express or implied new promise to pay and the statute is revived for the whole period beginning with the date of acknowledgement. In (2) from a payment on account, either principal or interest, a new promise to pay is implied and starts the running of the statutory period anew. Consideration for the new promise is not needed.

c. The date on which the statute will start running is June 1, 1952. If a payment is made before the statutory period has fully expired, the implied new promise to pay starts a new period running in place of the partly expired one.

Solution 7

a. A bulk sale is a sale by a merchant of all or a substantial part of his stock of goods, not made in the ordinary course of his business.

b. The purpose of bulk sales laws is to prevent fraud upon creditors which could result from a merchant buying goods on credit from wholesalers and jobbers, selling such goods in bulk to an innocent purchaser for value, and then failing to pay his creditors.

c. In general, bulk sales laws provide that one who purchases the major part or all of the seller's merchandise must obtain from the seller a list of all of his creditors with their addresses and the amount owing to each. The buyer must then give each of the creditors personal or written notice of the pending sale, with the terms thereof, a stated time before possession is taken and payment made. This gives the creditors a period in which to protect their interests, if desirable. If the buyer fails to comply with the law and the seller's creditors are not paid, he is liable to them for the value of the property received. In most states he has no personal liability beyond the value of the goods purchased by him.

Solution 8

a. A rubber stamp signature is sufficient. The N.I.L. requires only that a negotiable instrument be signed by the maker or drawer. This requirement is held to be met by any form of signature such as printed, typed, written, lithographed or stamped.

b. The phrase, "If at any time the holder of this note shall so desire he may declare the note due immediately," makes the note non-negotiable. This phrase violates that provision of Section 1, subsection 3 of the N.I.L. which states that to be negotiable an instrument must be payable on demand, or at a fixed or determinable future time. While Section 4, subsection 2 of the N.I.L. provides that an instrument is payable at a determinable future time when it is payable on or before a fixed or determinable time fixed therein, and such instruments giving the *maker* the unrestricted right to accelerate the time of payment are considered negotiable, such instruments giving the *holder* the unrestricted right to accelerate the time of payment are considered non-negotiable because in such latter case the holder's unrestricted option makes the time of payment uncertain. In the question the option is not that of the maker but that of the holder, and so the instrument is not negotiable.

While a note payable on demand would meet the requirement of a time certain for payment, Hornblow's note cannot be considered a demand note since an option giving the holder of a time note an unrestricted right to declare it due immediately is considered to make the time of payment uncertain and the instrument therefore non-negotiable.

c. Yes. If Hornblow can show that the securities were worthless he would have a personal defense (failure of consideration). Such a defense is not good against an innocent holder for value of a negotiable instrument but is otherwise a good defense. Since this instrument is not negotiable because of the holder's unrestricted option to accelerate the time of payment, the transfer to Snapp was an assignment of the rights of Spinx, and Hornblow can maintain his defense as against Snapp.

Solution 9

a. As to the 16 dining room sets unsold out of Job 132, the loss falls on the company.

According to Section 22 of the *Uniform Sales Act* the risk of the goods is on the buyer when the property therein is transferred to the buyer. As to the four dining room sets awaiting shipment, which were unascertained goods sold by description, the property therein was transferred as soon as they were appropriated to the contract. (Sec. 19, Rule 4(1) and (2).) This would have occurred when they were placed in the carrier's freight car. As to the living room set, which comprised specific goods to which the seller was bound to do something to put them into a deliverable state, the property in it passed when such thing was done. (Sec. 19, Rule 2.) Thus in the case of the four dining room sets and the living room set the loss falls on the buyer.

b. The measure of loss is ordinarily the actual or fair cash value at the time of loss. Where goods have been manufactured, fair cash value is considered to be cost of *replacement* and not selling price. Indemnity does not ordinarily include any allowance for a possible or potential profit unless a special policy is obtained. Therefore the loss on the sixteen dining room sets owned by the City Furniture Co. is measured by replacement cost and this may be higher or lower than original cost of production.

Solution 10

a. B may recover from A for breach of implied warranty. The fact that B asked for the ice cream by brand name does not negate the implied warranty of fitness for human consumption made by a seller of food. Also in this case the retail packaging was done by A, and while A would not be liable if B had asked for a carton of the specific brand of ice cream originally packaged and sealed by the manufacturer, the fact that the bulk ice cream was in a carton filled by A has no bearing on his specific liability.

b. The general rule has been that B cannot recover from the manufacturer in such a case for breach of warranty. Warranties exist basically only as between parties having direct contractual relations. As there was no contract or sale between the manufacturer and B, there was no privity of contract creating warranties.

However, in recent years there have been cases giving to ultimate purchasers or consumers having no contractual relationship with the manufacturer a right of action against the manufacturer for breach of warranty. These cases have treated the imposed warranty as running with the product.

While the manufacturer may also be liable to B for damages in a tort action for negligence, there is a material difference between an action for breach of warranty and a tort action for negligence in that in the former the defendant must prove his freedom from negligence, and in the latter the plaintiff must prove the defendant was negligent.

Solution 11

a. "Oppressive child labor" means a condition of employment under which (1) any employee under the age of sixteen years is employed by an employer (other than a parent or a person standing in place of a parent employing his own child or a child in his custody under the age of sixteen years in an occupation other than manufacturing or mining or an occupation found by the Secretary of Labor to be particularly hazardous for the employment of children between the ages of sixteen or eighteen years or detrimental to their health or well-being) in any occupation, or (2) any employee between the ages of sixteen and eighteen is employed by an employer in any occupation which the Secretary of Labor shall find and declare to be particularly hazardous for the employment of children between such ages or detrimental to their health or well-being.

b. No. The basic provisions of the law requiring a minimum wage and time-and-a-half for hours in excess of a forty-hour workweek are specifically barred from application to any employee employed by any retail or service establishment more than 50 per cent of which establishment's annual dollar volume of sales of goods or services is made within the state in which the establishment is located. A "retail or service establishment" means one where 75 per cent of the annual dollar volume of sales of goods or services is not for resale and is recognized as retail sales or services in the particular industry.

c. Any employer violating the provisions of Section 6 or Section 7 of the Act is liable to the employee or employees affected in the amount of their unpaid minimum wages, or their overtime compensation, as the case may be, and in an additional equal amount as liquidated damages. (subsec. (b), Sec. 16, *Federal Fair Labor Standards Act.*) But if in any action to recover unpaid minimum wages, unpaid overtime, or liquidated damages, the employer shows to the court's satisfaction that the omission was in good faith and that he had reasonable grounds for believing it was not a violation of the *Fair Labor Standards Act,* the court may, in its discretion, award no liquidated damages or award any amount thereof not to exceed the amount specified in subsection (b), Section 16, *Federal Fair Labor Standards Act.* (Sec. 11, *Portal-to-Portal Act* of 1947.)

Theory of Accounts

November 9, 1956; 1:30 to 5:00 p.m.

GROUP I

Solution 1

a. 1. b.	*b.* 11. e	*c.* 16. a
2. d	12. b	17. d
3. d	13. b	18. a
4. c	14. e	19. d
5. e	15. a	20. c
6. a		
7. a		
8. b		
9. b		
10. d		

Solution 2

A change in the amount of annual depreciation recorded does not change the facts about the decline in economic usefulness. It merely changes reported figures.

Depreciation in accounting consists of allocating the cost of an asset over its useful life in a systematic and rational manner. Abnormal obsolescence, as suggested by the chief engineer, would justify more rapid depreciation, but increasing the depreciation charge would not necessarily result in increased funds for replacement. *It would not increase revenue* but simply make reported income lower than it would have been, thus preventing overstatement of net income.

Recording depreciation on the books does not set aside any assets for eventual replacement of the depreciated assets. Fund segregation can be accomplished but it requires additional managerial action.

Unless an increase in depreciation is accompanied by an increase in sale price of the product, or unless it affects management's decision on dividend policy, it does not affect funds. Ordinarily higher depreciation will not lead to higher sales prices and thus to more rapid "recovery" of the cost of the asset, and the economic factors present would have permitted this higher price regardless of the excuse given or the particular rationalization used. The price could have been increased without a higher depreciation charge.

The funds of a firm operating profitably do increase, but these may be used as working capital policy may dictate. The measure of the increase in these funds from operations is not merely net income, but that figure plus charges to operations which did not require working capital, less credits to operations which did not create working capital. The fact that net income alone does not measure the increase in funds from profitable operations leads some non-accountants to the erroneous conclusion that a fund is being created and that the amount of depreciation recorded affects the fund accumulation.

Acceleration of depreciation for purposes of income tax calculation stands in a slightly different category, since this is not merely a matter of record keeping. Increased depreciation will tend to postpone tax payments, and thus temporarily increase funds (although the liability for taxes may be the same or even greater in the long run than it would have been) and generate gain to the firm to the extent of the value of use of the extra funds.

Solution 3

a. Four of the terms include the word "Reserve." Suggested alternate wording for each of the terms follows:

(1) "Reserve for bad debts" replaced by "Less allowance for doubtful accounts," or "Less estimated losses in collection"

(5) "Reserve for contingent liabilities" replaced by "Estimated liabilities," or "Liabilities of estimated amount"

(6) "Reserve for income taxes" replaced by "Taxes on income," or "Estimated taxes on income"

(8) "Reserve for inventory decline" replaced by "Appropriated for possible future decline in inventories," though "Reserve for inventory decline" would still be permissible

(2) The change proposed for the word "Profit" provides for replacement of "Net profit" by "Net earnings"

Three terms involve the word "Surplus." Possible changes are as follows:

(3) "Earned surplus" replaced by "Retained earnings"

(4) "Paid-in surplus" replaced by "Additional paid-in capital," or "Capital contributed in excess of par value of stock"

(7) "Reappraisal surplus" replaced by "Appreciation of fixed assets"

b. In order to clarify the term "Reserve" the above changes were suggested by the Committee on Terminology. Formerly the term "Reserve" had been used in three senses:

(a) As a valuation reserve, whereas in reality its function is to indicate a decrease in an asset due to a specified cause. Therefore, the term "Reserve" should be replaced by terms which indicate the measuring process, such as "Allowance for bad debts," and "Accumulated depreciation."

(b) To indicate an estimate of a liability such as a disputed claim or provision for self-insurance. Used in this sense the term "Reserve" indicates that a portion of assets would be required for its discharge, whereas it is preferable to indicate the obligation itself as a necessary deduction to arrive at net assets. Such designations might be "Estimated taxes on income," or "Liabilities of estimated amounts."

(c) To indicate that a stated amount of the undivided portion of the net assets is being held for a special purpose, such as for possible future inventory losses. While the use of the term "Reserve" might be used in this area, it would be preferable simply to state the reason for the appropriation of the retained earnings, such as "Appropriated for possible future decline in inventories."

The term "Statement" should be used to indicate the financial statements that are prepared from the aggregate of ledger accounts. Former usage applied "Profits" to manufacturing and mercantile concerns, and "Income" to the compensation received by an individual. However, there has been a tendency to substitute the terms "Income statement" or "Statement of earnings" for the term "Profit-and-loss statement" with the thought that the terms "Income" or "Earnings" were more all-inclusive and were a resultant of the positive and negative elements.

The use of the term "Surplus" has a connotation of "Excess" or other meanings which are not in accord with the intended use of the term when used in accounting. Therefore, the committee suggested the general discontinuance of the term "Surplus" in corporate reporting and a substitution of terms in the capital section of the balance sheet which would show:

(a) The legal capital; ("Capital stock")
(b) The capital in excess of legal capital (Additional paid-in capital")
(c) The earnings retained in the business ("Retained earnings")
(d) In connection with the retained earnings, the extent to which they had been appropriated or restricted as to withdrawal ("Retained earnings appropriated for possible future decline of inventories")
(e) Any appreciation included in the stockholders' equity on the balance sheet should be so indicated ("Appreciation of fixed assets")

Solution 4

The $10,000 should be charged to the building account, or to a separate building improvement account, the cost to be depreciated or amortized over the estimated useful life of this remodeled store front.

Although it may be true that this expenditure did not add any "value" to the building from the standpoint of its resale price, this is no reason for charging off the $10,000 expenditure as a loss, or as an expense of the current period. The purpose of accounting for such expenditures is not primarily to give reasonably sound valuation of fixed properties, but rather to match the cost with the revenue emerging as a result of such expenditure. The store front was remodeled in order to attract customers or otherwise as a reasonable expenditure for the operation of this type of business. Such expenditure was made in anticipation of its relationship to the production of revenue in future periods, and therefore the cost should be spread over such time as it is anticipated that it will be useful in the earning of this revenue. This period of time might be the remaining life of the building, if it is assumed that no additional remodeling will take place, or a shorter period of time, if it is felt that subsequent remodeling may be necessary in order to keep the store front "up to date."

Also under the facts stated, the remodeling was done immediately after purchase of the building. As a general rule the costs incurred to make a second-hand asset useful are regarded as a part of the asset cost. This rule would hold for a building as well as for a machine.

Solution 5

a. The entry to record the transaction on January 2, 1955 would be as follows:

Cash	$1,100	
Sales of machines		$900
Liability for maintenance service		200

The facts indicate that the company is engaged in two separate, but related activities, on both of which it presumably expects to make a profit. Since it is selling a maintenance service, it is not in the same position as a company which merely sells a product which it warrants for a period of time. In that situation a portion of sales price is presumed to cover the costs incurred under the warranty, but not to include profit on the servicing work. In the case of the Manufacturing Company the service division is a separate operation. For accurate measurement of its results we should record $100 of the original sale price of a machine as applicable to servicing. Clearly the 1956 service contract should be recorded as a liability for future service at the agreed fee.

b. At December 31, 1955 the following entry would be made:

Liability for maintenance service	$100	
Income from service agreements		$100

The 1955 contract price has been earned and should be transferred to income. The liability for 1956 service is still unfulfilled. The fact that service costs average $62 instead of $60 requires no entry since such costs are recorded in appropriate expense accounts at actual amounts as incurred.

c. The tax treatment would not be the same. The entire $1,100 would be reported as income in the year (1955) of receipt.

Solution 6

a. The purpose of the bond sinking fund was to assure eventual retirement of the bonds by requiring the corporation to set aside sufficient funds each year (usually placed in the custody of a trustee) so that at the maturity date there would be sufficient funds available for their retirement. Without such a provision, the bondholders would have less assurance that the corporation would be in a financial position to repay at maturity. Such a provision, therefore, makes the investment in these bonds more attractive, and hence is not only an advantage to the purchaser of the bonds, but also is helpful to the corporation because it is easier to market the bonds—and probably at a better price, or at a lower interest rate.

The sinking fund reserve is created and increased by an entry debiting retained earnings and crediting reserve for bond sinking fund. This entry merely reduces one retained earnings account (the basic or unappropriated retained earnings account) and increases another retained earnings account (a restricted or appropriated retained earnings account). Its general purpose is to restrict dividends through the reduction of the retained earnings account, and thus to protect the current position of the company. At the same time that cash is being transferred to the trustee for sinking fund purposes, and thus reducing current assets, the sinking fund reserve provision serves to reduce dividends paid (frequently in like amount), thus keeping the current assets from being further reduced through dividend payments of amounts equal to those that might have been paid in the absence of these bond requirements. Of course, dividend payments might have been reduced without such sinking fund reserve provisions, but such provision gives added assurance to the bondholders.

b. It is not easy to say what should be done with the reserve for bond sinking fund account after the bonds are retired. One possibility is to return the reserve to retained earnings, but this may be objectionable because the corporation will presumably be in no condition to pay additional cash dividends, or at least not to the extent indicated by the increase in unappropriated retained earnings. However, since management must consider the working capital situation of the company before declaring cash dividends, there may be no major problem presented by such a treatment.

A satisfactory solution might be for the corporation to declare a stock dividend in the amount of this sinking fund reserve. This would be logical, because the entire process of plant expansion and ultimate bond retirement has resulted in the stockholders having financed the expansion out of earnings. (The direct financing was from the proceeds of the bond issue, followed by accumulation of funds out of earnings, restriction of dividends during the period of accumulation, and utilization of these funds for the retirement of the bonds.)

Another possibility having similar effect would be transfer of the sinking fund reserve to capital stock, in accordance with action by the board of directors increasing the stated value of the stock by this amount.

Instead of any of the above possibilities, the sinking fund reserve account could be left undisturbed. Or, the sinking fund reserve account could be closed out and credited to a special account with some such title as "Retained Earnings Invested in Plant and Equipment." Although this latter treatment reflects what has actually happened, it has an objectionable feature. It is quite probable that other amounts of retained earnings have been invested in plant and equipment over a period of time, and hence this special account used in this particular instance might be confusing.

Solution 7

Henry Brown's executor, on his behalf, will have to file a gift tax return and pay the tax on $575,000 (current value) less exclusions, exemptions and the marital deduction. (If the wife agrees, there may be excluded $6,000 of the gift to the daughter, and $60,000 will be exempt provided neither Brown nor his wife had used any part of their $30,000 exemption. If the wife doesn't agree, there would only be a $3,000 exclusion for the gift to the daughter and a $30,000 exemption. In any case, there will be a $3,000 exemption for the gift to the wife and a marital deduction of $175,000. If the consent of the wife is given, separate returns and calculations will be made for Brown and for Mrs. Brown.)

Since the gift was made in contemplation of death, the estate tax base will include the property mentioned at its current value ($575,000). Use of the optional valuation date is not permitted. Credit will be received for the gift tax paid, which will also be a liability deductible in determining the adjusted gross estate and net estate.

The estate will be allowed a marital deduction which may include the stock given to the wife (subject to the maximum allowance) which would not have been true if she had had only a life estate in the stocks.

There is no income tax problem involved, since the adoption of the Internal Revenue Code of 1954. The stock and bonds will have a basis in the hands of the wife and daughter equal to the estate tax valuation. Prior to that the bonds would have had a basis in the daughter's hands of $200,000 and the stock would have had a basis in the wife's hands of $400,000 for gain purposes and $350,000 for loss purposes. Had they remained in his estate (prior to IRC 1954) the value at date of death would have governed.

Stamp taxes will, of course, have to be paid on both transfers.

Solution 8

a. Alternative (4), preparing consolidated statements, seems to be preferable. Such statements would disclose the financial position (including the assets underlying the investment in Excelsior) and results of operations. Alternative (1) fails to disclose material facts. Alternative (2) would be a full disclosure. Alternative (3) would not be correct because Acme is not indebted directly to the bank and has no receivable from Excelsior until such time as Acme is called upon to make good on its guarantee. The writing down of the investment is not justified unless Acme elects to adjust the investment each year for Excelsior's profits or losses. The alternative also does not disclose Excelsior's position.

As indicated, if consolidated statements are not prepared a footnote should disclose the 100 per cent ownership, the net loss of $17,500 in 1955, which has not been taken up by Acme and the amount and nature of the contingent liability.

b. Inquire whether Medium Company includes its subsidiaries in consolidated statements, stating that this probably will be necessary in order to show the financial condition of the group and the results of its operations. In such a case the subsidiary which will acquire Little Company will have to be included in such statements. The liability of this subsidiary for the installments will appear as a direct liability of the group and no footnote will be necessary. If consolidated statements were not prepared, *the contingent liability* would have to be disclosed.

Solution 9

a. Prepaid subscriptions are liabilities. If the publishing company on whose balance sheet the item appears is operating profitably the liability will be less than the amount of the prepaid subscriptions because it includes an undetermined amount of net income.

Of its very nature income cannot be deferred. What can be deferred is the recognition of it. Conventionally, income is recognized and recorded when it is realized. The receipt of advance subscriptions is not considered the realization of income. The latter occurs when the magazine or periodical is mailed to the subscriber. The true relationships may be illustrated by the following entries:

(1) Cash	$100,000	
Subscriptions received in advance		$100,000
To record receipt of subscriptions		
(2) Subscriptions receivable	18,000	
Subscription revenue		18,000
To record subscription income earned		
(3) Subscriptions received in advance	18,000	
Subscriptions receivable		18,000
To offset reciprocal receivables and payables		

While (2) and (3) may be telescoped into one entry, nevertheless, a claim against subscribers did come into being and was settled, by prior agreement, through the subscriptions paid in advance.

Although they are true liabilities such prepayments are probably shown separately because they differ from the conventional liability in a most important characteristic—they will not be settled by a payment of cash to the creditor, but by the delivery of a magazine or periodical.

b. In determining the proportion of income which should be deferred, consideration should be given to the cost of fulfillment. The amount should not normally be less than such cost. Cost of obtaining the subscription may also be considered since that cost has been incurred in full. Theoretically, the total five-year price should cover cost of obtaining subscriptions, cost of fulfillment and a profit. Cost of obtaining the subscription has been incurred and a portion of the price equal to that cost should be used to offset the expense in the year the subscription is obtained. Also, a proportionate part of the price, based on time, should be taken into income as realized. Apart from theoretical considerations, the practice of the industry should be considered. Also, there may be difficulty in arriving at the data needed for making the apportionments suggested above as desired.

Solution 10

a. The valuation of the property should be stated as being at cost. The valuation of $900,000 recorded in the property accounts can be considered a *fair valuation of the property at the time it was acquired,* which, based upon the report of a qualified appraisal company, was less than the fair market value at the time of acquisition. This is in accord with the generally accepted accounting principle that assets should be stated at cost when they are acquired. In the case of non-cash acquisitions, cost may be considered as being either the fair value of the consideration given or the fair value of the property acquired, whichever is the more clearly evident.

The fact that the company waited until December before setting a value for the property is not significant since this is an appropriate adjustment of the October entry. The situation here is clearly distinguishable from a case where a company writes up property which it has held for several years. This is *not a "reappraisal"* by the Florida Real Estate Company.

b. The capital surplus should be described as follows:

"Capital surplus—excess of valuation of property at date of acquisition over par value of capital stock issued therefor."

Solution 11

(1) Company B could accept the offer and purchase the stock of Company A. It would, within a twelve-month period, liquidate Company A and allocate $10,000 to the fixed assets and $15,000 to the laundry route.

(2) Fixed assets at the appreciated valuation of $10,000 would be charged off to depreciation based on the estimated life of ten years at $1,000 per year.

(3) When the operations at the present location of Company A are abandoned, the $15,000 for the laundry route would be charged off against the current year's income and any remainder of such loss could be carried back against the income of the last two years and carried over for five years.

If Company B were to purchase the stock of Company A and leave it in existence, Company A would be entitled to depreciation on the fixed assets of $5,000 only and would not be entitled to any loss on the laundry route, which has a zero basis in its hands. Company B could not take a loss on the liquidation of its subsidiary. In this case B has not been offered the opportunity to purchase the net assets of A, and there may be strong practical reasons which make it impossible to do so. If it were feasible to acquire the net assets, the same tax situation could be obtained in that manner.

INDEX

Accommodation party
  Define 117
Accord and satisfaction
  Define 120
Account stated
  Define 120
Accountant's liability
  False registration statements 212
Accountant's responsibilities
  Failure of client in another state to keep proper records 123
Accounting
  Testimony as to conformity with generally accepted accounting principles 79
  Unauthorized practice, by corporations 72
Accounting Practice, Part I, questions in 1, 37, 87, 136, 180, 224
Accounting Practice, Part II, questions in 11, 45, 98, 145, 190, 236
Accounting research bulletins
  Amortization of emergency facilities, why bulletin was necessary 33
Accounts receivable
  Confirmation, company records not maintained to permit, audit procedures, disclosures, qualifications 252
  How shown on balance sheet 98
  Journal entries to record necessary adjustments 98
  Schedule, showing recorded transactions 98
Accumulated earnings
  Payment of dividend on common stock, preferred stock 33
Act of God
  Define, as to carriers 27
Agency
  Actual and ostensible, distinguish between 123
  Agent and principal, duties 69
  Coupled with an interest, define 69
  Creation of, state ways 258
  Disqualification as, state circumstances when person is competent 258
  Express and implied, distinguish 123
  General and special, distinguish 123
  Liability of principal for crimes of agent 69
  Principal without power to revoke 69
  Unauthorized act by agent, remedy by subsequent approval 258
  Undisclosed principal, define 69
Allowance (reserve) for cash discount on sales
  Nature of, and classification in financial statements 223
Annuities
  Amount available after retirement, compute 96
  Inclusion in gross income 136
Apartment houses
  Prepare journal entries on buyer's and seller's books 45
Arbitration
  Sale of goods settled by 73
Assets
  Fixed, fully depreciated, merged with other assets on balance sheet, discuss propriety of accounting treatment 127
  Fixed, fully depreciated, still in use, discuss 127
  Fixed, procedures necessary in auditing accounts 247
  Undervaluation of, discuss company policy 32
  Valuation of, in foreign exchange, how shown on balance sheet of parent and branch 133
Assignments
  See Contracts
Attorney in fact
  Define 258
Audit program
  Common trust fund, to determine net book value, amount of income and gain or loss 208
  Examination of company's tax position 205
  Examination of hourly payrolls during "preliminary work" 20
  Hourly payrolls during "final work" 20
  Manufacturing company 63
  Outline for verification of social security and unemployment taxes 18
Auditing
  First engagement, audit program for examination of company's tax position 205
  First engagement, balance sheet presentation of income taxes payable 205
  First engagement, work program 110
  Questions in 16, 57, 109, 153, 200, 246
  Termination of audit because of delay in completion, recovery of compensation 117

INDEX

Bailment
- Appropriate care by bailee 29
- Basic obligations of bailors and bailees 258
- Pledge, define 258
- Reimbursement expenses of bailee 29

Balance sheet
- Audit 18
- Capital section, prepare for report 91
- Change terminology to conform with generally accepted accounting principles 35
- Consolidated, prepare 6
- Consolidated, prepare worksheet and supporting schedules, explain entries 188
- Date, events occurring subsequent to 59
- Prepare, for electric appliance business 2
- Presentation of items 46

Bank balances 46
- Reconcile for financial statements 46

Bank deposits
- Rights of parties after bank's insolvency 167

Bankruptcy
- Adjudication, petition to reorganize filed prior to 71
- Arrangement, state points before Court will confirm 71
- Of partner, dissolution of partnership 122
- Percentage of recovery by unsecured creditors, compute 50
- Preference of claims for salary due 71
- Reorganization petition, state subjects of statements set forth in 71
- Review of books and records, statements for creditors' committee 134

Bidding
- Advertisement as offer to contract 215

Bill of exchange
- Drawer and drawee same person, how treated by holder 165

Black biscuit company
- Audit 155

Bonds
- Interest on, entries and disclosures in accounting records and statements 109
- Pledged, income on 167
- Sinking fund reserve, disposition after retirement 266

Books
- Advantages of, explain 37

Breach of contract
- *See* Contracts

Budgets
- Municipal, outline accounts necessary for control 248

Bus company
- Audit 21

Buying a business
- Data for use in evaluating financial condition 255
- Purchase of laundry to secure maximum tax advantage 270

Calendar year
- Advantages over natural business year 176

Capacity
- Define and describe differences in expected capacity, average capacity, practical capacity 222

Cash discounts
- Treatment of 31

Cash fund
- Petty, composition, audit procedures for verification 204

Caveat emptor
- Classifications of sales as exceptions 24
- Common law rule of, define 24

Charter
- Corporation, issued under statute declared unconstitutional 168

Chattel mortgages
- Conditional sales and, difference between 68

Checks
- Signed in blank, recovery of raised amount by holder in good faith 69

Choses in action
- Common forms, list 119
- Define 119

Clerical work
- Internal control 246

Coal mining
- Royalties due under lease 202

Colleges
- Fund balance sheet 53
- Skeleton ledger accounts, prepare 53

Commercial law
- Questions in 24, 67, 117, 163, 210, 257

Common carrier
- Distinguish between private carrier and, as to liability 27
- Liability, nature and extent of 27
- Lien, nature and scope of 27

Common trust fund
- Audit program to determine net book value, amount of income and gain or loss 208

Concrete pipe
- Cost, profitability, inventory valuation of each size, compute 141

Consent decree
- Define 169

Consolidated statements
- *See* Statements

INDEX

Construction
- Joint venture, overhead payment, income 179
- Percentage of completion method, describe 221
- Percentage of completion contract, balance sheet, statements of income and retained earnings 138
- Recommended accounting classification, advantages and disadvantages, effect on maintenance and depreciation 176
- Retained percentages receivable, subcontractors' estimates payable, bid deposits, contracts in progress, explain 221

Contracts
- *See also* Government contracts
- Acceptance of offer in specified way 215
- Acceptance of written offer, without reading 215
- Assignment of rights under 67
- Assignments of listed accounts receivable 163
- Assignments, valid as to creditors 163
- Bilateral and unilateral difference 67
- Breach of, failure to make delivery as 70
- Breach of, in failure to deliver stock 211
- Breach of, in failure to meet report deadline 259
- Breach of, recovery of damages 26
- Breach of, suit to recover for compensation 164
- Breach of, zoning ordinance prohibiting fulfillment as 70
- Clause relieving party from liability for negligence 169
- Concurrent, define 67
- Detriment, define 166
- Fraudulent, remedies of defrauded party 213
- Illegal, enforceability 169
- In restraint of trade, enforceable or unenforceable 169
- Insurance, made without consideration 30
- Offer by mail 215
- Offer intended for one, accepted by another 215
- Offers made in jest, validity 215
- Oral, of fire insurance 30
- Precedent, define 67
- Quasi and implied in fact, distinction 215
- Rescission of 24
- Subsequent, define 67
- Threats to obtain consent to 72
- Unenforceable, questions on 169
- Void as to mutual mistake in subject matter 214

Corporations
- Capital section of balance sheet, prepare for report 91
- Charter issued under statute later declared unconstitutional 168
- Promoter cannot take secret profit 168
- Sale of assets, terminates existence of 215
- Stock dividend may be rescinded prior to issuance 168
- Subscription rights are deemed principal 168

Costs
- Sales price per unit, ratio of gross profit, compute 234

Creditor and debtor
- *See* Debts and debtors

Cutlass dress manufacturing corporation
- Audit 98

Cut-off
- Define 61
- Interpretation of, application of various items 61

Cycle billing
- Unbilled revenues, compute 234

Damages
- In excess of company's net worth, audit procedures, disclosures, qualifications 252
- Payment of, entries and disclosures in accounting records and statements 109

Debts and debtors
- Creditors' composition agreement, questions on 166
- Forgiveness of balance, on partial payment 35
- "In full payment" condition accepted by creditor 166

Deferred charges
- Nature and disposition 177
- Prepaid expenses and, distinction between 177
- Setting up net operating loss 85

Deferred income
- *See* Income

Depreciation
- Fixed assets, accounting concept 263
- Machinery, compute by various methods 148
- Methods, prepare statement explaining 242
- New machine, arguments for and against various methods 131
- Old factory building, discontinuance of taking 31
- Revision of estimate as to remaining life, how shown in statement 128
- Summary of property and allowance based on certain methods 242

INDEX

Detriment
  Define 166
Development
  See Research and development
Deviation
  Define, as to carriers 27
Directors
  Bankruptcy of, disqualified to hold office 215
  Board of, functions and duties 73
  Breach of duties, third party liability for inducing 215
  De facto, define 215
  Liability for breach of fiduciary duties 215
  Meetings outside state in which corporation was created 215
  Perpetuation in office 215
  Power to act as corporate agent 215
  Resignation of, before successors are elected 215
  Services to corporation in other capacity, compensation 215
Disclosure
  See Statements
Dividends
  Declaration of common stock, entries and disclosures in accounting records and statements 109
  Entry to record receipt of 33
  Payment from accumulated earnings for, on common and preferred stock 33
  Stock, capitalization of retained earnings 82
  Stock, note for statement on basis of accounting 229
Domby distilleries, inc.
  Fire loss 103
Dress manufacturing
  Audit 98
Electric appliance manufacturer
  Audit of receivables 112
Electric appliance retailer
  Installment sales 4
  Preparation of balance sheet and income statement 2
Eminent domain
  Define 120
Estate tax
  Tax problems in estates and gifts of stock 268
Expenses
  Losses and, distinguish between, differences in accounting treatment 177
  Prepaid, and deferred charges, distinction between 177
Expert witness
  See Testimony
F.O.B. sales contract
  Define 119
Fair labor standards act
  Activities covered by 74
  Application of minimum wage and overtime provisions 262
  Maximum hours before payment of overtime 74
  Minimum wage and overtime provisions, recovery of amount of underpayment 262
  Minimum wage rate 74
  Oppressive child labor, define 262
  Rate of overtime compensation 74
  Regulatory provisions, state nature 124
Federal securities act
  Damages in civil liability suits on false statements 212
  Liability of accountants for false registration statements 212
  Regulatory provisions, state nature 124
Federal securities exchange act
  Regulatory provisions, state nature 124
Federal trade commission
  False advertising 169
  State purpose 169
Fire insurance
  See Insurance, Fire
Fixed assets
  See Assets
Florists
  Advantages of simple set of books, explain 37
  Worksheet, prepare 37
Footnotes
  Contingent liability from guarantee in 268
  Necessary, for statement presentation 93
Foreign bill of exchange
  Inland bill, distinguish between 165
Foreign exchange
  Change in rate of, journal entries 133
  Gain or loss from translation, how shown in balance sheet 133
  Valuation of assets, how shown in balance sheet 133
Fraud
  Actionable, basic elements 213
  Actual and constructive, distinguish 213
  Contracts, remedies of defrauded parties 213
  Duress and undue influence, distinguish 213
  Innocent misrepresentation and, difference 214
  Misrepresentation, silence constituting 213
Funds
  College 53
  Common trust, audit program to determine net book value, amount of income and gain or loss 208

Current, composition and significance of amounts included in surplus 130
General and plant, prepare journal entries and balance sheet 142
Municipal, prepare balance sheet 187
Municipal, prepare statements 7
Source and application of, decrease in net working capital 149
Source and application of, prepare statement 11
Furniture company
Prepare statements 50
Goods
Define, within meaning of Uniform sales act 163
Future, present sale, effect of agreement 163
Government contracts
Annual or monthly rates, use of direct-labor-hour rate, discuss 79
Testimony as to conformity with generally accepted accounting principles 79
Grocery retailers
Partnerships, prepare cash payment schedule, profit and loss and taxable income statements 145
In good faith
Under Uniform sales act, thing done honestly but negligently 163
Income
Deferred, on subscriptions 269
Net, changes in profit to arrive at corrected 91
Income statements
See Statements
Income tax
See also Tax returns
Accrual basis, medical expenses of taxpayer on 11
Additional assessment for, how shown in statements 128
Alimony payments 11
Annuities, inclusion in gross income 136
Audit program for examination of company's tax position 205
Basis of stock for estate tax purposes 136
Calendar-year taxpayer on accrual basis 11
Capital gain on cutting timber 42
Cashable coupons, interest 11
Casualty loss 11
Christmas bonus 11
College student, deduction for, by parent 136
Corporation, disallowance of deductions, recourse to agency 136
Corporation, obsolete equipment sold as scrap 136
Corporation on accrual basis 11
Corporation, security transactions, capital loss carry-over 136
Correctness of reported net income 1
Deduction of loss on car sale 11
Deductions for contributions 11
Deductions, for support of child 11
Deductions, on alimony 11
Deductions, sale of stock 11
Depletion deduction after full cost has been recovered 136
Dividend income subject to tax 11
Estimated tax declaration 136
Gain or loss on stock 11
Improvements made by lessee 11
Inclusion in current year's return of dividend credited but not withdrawn 136
Infant's tax return 11
Installment method for sales of personal property 11
Interest on state and municipal bonds, exemption 136
Interest on U.S. government bonds and securities 136
Joint declaration of estimated tax 11
Joint return, brother and sister 11
Joint return of separated couple 11
Liability, compute 190
Loss on property 11
Medical deduction for blind person 136
Medical expense deduction 11
Methods of determining periodic income 33
Net operating loss, years deductible 136
New York state, deduction from federal tax 136
Non-business bad debt 11
Officer's salary deduction for corporation on accrual basis 11
Partnership, gain on sale of asset as ordinary net income 11
Partnerships, allowance for contributions 11
Patents, sale of, transfer of rights 136
Payable, balance sheet presentation 205
Penalty for underestimation 136
Property contributed by partner 11
Property, holding period 11
Provision for taxes where depreciation differs from amortization, journal entry 190
Rebate for deferable tax applicable to inventories 13
Sale of inventory and fixtures, discuss problems 80
Schedule of business income 1
Schedule of gain on sale of apartment house, prepare 45

INDEX

Summer job of minor 11
Tax return of decedent 11
Indexes
"General" price and cost of living, arguments for and against each 221
Indorsements
By agent on negotiable instrument 165
By holder in trade or assumed name, on negotiable instrument 165
By minor, on negotiable instrument 165
By payee, on negotiable instrument, name incorrectly spelled 165
Conditional, define and give example 117
Qualified, define and give example 117
Restrictive, define and give example 117
Infant
Necessaries, requirements of collection of price by supplier 163
Inland bill
Foreign bill of exchange and, distinguish between 165
Installments
Gross profit percentages, compute 4
Guarantee, contingent liability arising from 268
Ledger accounts for contracts receivable 4
Net loss on defaulted accounts, calculate 4
Schedule of realized gross profit 4
Tax problems 36
Insurable interest
Beneficiary in life insurance contract 30
Creditor in life of debtor 30
In fire insurance, what constitutes 119
In lease 30
In life of insured 30
Unsecured creditor in property of debtor 30
Insurance
Contract made without consideration 30
Insurance, Fire
Amount recoverable and formula used, compute 101
Balance of fire loss account, compute 101
Co-insurance clause, amount collectible by insured 30
Floating policy, define 119
Insurable interest, define 119
Insurable interest must exist at time of loss 212
Inventory on hand after fire, determine 239
Loss, measure of, who bears risk 260
Losses, compute amount company would receive as result of 239
Oral contract 30
Policies, amount recoverable under pro rata and co-insurance clauses, compute 119
Policies on mortgaged property, rights of mortgagor and mortgagee, explain 119
Prepaid insurance on balance sheet 171
Proceeds re-invested in similar property, tax problems 101
Insurance, Life
Creditor has insurable interest in life of debtor 30
Insurable interest in life of insured 30
Insurable interest need exist only at time policy is issued 212
Judgment creditors and proceeds 30
Insurance, Title
Define 122
Intercompany accounts
Journal entries required by each company 184
Reconciliation 184
Interest
Compound, compute 8
Legal rate of, rule as to mistake of law 214
Internal control
Audit procedures in interim and year-end examinations 157
Audit program 157
Clerical operations 246
Measures to provide, list 113
Purpose and factors in effective operation 113
Inventories
Accuracy of 62
Adjusting journal entries 16
Amount on hand after fire 239
Change of method, how shown in statement 126
Cost of, list items included 174
Examination of, in distant warehouse, audit procedures, disclosures, qualifications 252
Flow of materials schedule, reconcile factory and accounting department records 246
Income tax problems in selling inventory 80
Lifo, advantages and disadvantages 171
Lower of cost or market, consistent and conservative, discuss 126
Methods used in valuation in specific circumstances 263
Observation of, list items in 62
Observation of, work done for other accountants 23
On consignment in warehouses, verification 200

Perpetual, records operated on specific bases 263
Program for specialty store 115
Stabilizing, advantages 219
State position if procedures are not accepted 115
Statement, letter to accompany 106
Tool, program for substantiating 250
Unqualified opinion as to accuracy 62
Used car, computations for valuation 216
Valuation of, for balance sheet presentation 42
Value and composition of iron ore, prepare statement 106
Work-in-process, schedule showing details 241

Investigations
Purchasing department 21

Investment company
Examination of accounts and records 57

Iron ore
Costs of ore and value of inventory, prepare statement 106

Job orders
Audit of 58

Joint venture
Construction project, overhead payment income 179

Kiting
Audit procedures to detect 64

Labor costs
Analysis of variance from standard 186

Labor-management relations act
Regulatory provisions, state nature 124

Laches
Define 120

Lack of consideration
Small consideration held to be, outline point 67

Laundries
Purchase of, to secure maximum tax advantage 270

Leased machinery
Audit program to cover assets and related income and expense accounts 248

Leases
Insurable interest in 30

Liabilities
Contingent, arising from guarantee, in footnotes 268
Contingent, define 109
Contingent, methods of reflecting in financial statements 109

Lifo
Advantages and disadvantages 171

Litho press company
Audit of 58

Loans
Auditor's long-form report, information included in 206

Losses
Treatment of, in new business before realization of revenue 177

Lumber company
Capital gain on cutting timber 42
Valuation problems 42
Vouchers, items charged to fixed assets or expense 218

Machinery
Depreciation by various methods, compute 148
Exchange, entries on books for tax purposes 148
Service maintenance, journal entries, treatment for tax purposes 266

Management
Explain difference as to information in external and internal reports 84

Manufacturing company
Audit of 58, 63

Marco corporation
Examination of 109

Materials
Flow of, schedule of, reconcile factory and accounting department records as to inventory 246

Medical foundation
Funds, general and plant, prepare journal entries and balance sheet 142

Mortgage
Amounts received by mortgagees in foreclosure 211
Identify and define specific terms 211
In default, liability of buyer and seller 211

Municipal
Analysis of operating surplus of water department 187
Fund, prepare balance sheet 187
Fund, prepare statements 7
Operating statement of water department 187
Outline accounts necessary for budget control 248

Natural business year
Advantages over calendar year 176

Negotiable instruments
Accommodation party, define 117
Conditional indorsement, define and give example 117
Consideration on face 25
Death of drawee, presentment excused 25
Holder deriving through holder in due course, rights 25

INDEX

Holder's right to declare note due immediately 260
Indorsed by agent 165
Indorsed by holder in a trade or assumed name 165
Indorsed by minor 165
Indorsed by payee, if name is incorrectly spelled 165
Indorsement must be full transfer 165
Language rendering instrument non-negotiable, give example 117
Liability of person not a party to 117
Negotiability when holder elects to do something in lieu of payment 25
Non-prosecution of crime, note issued in consideration of, recovery by payee from maker 69
Payable to bearer where payee is fictitious, unknown to maker 25
Qualified indorsement, define and give example 117
Restrictive indorsement, define and give example 117
Rubber stamp signature on 260
Sum payable in, including interest, is sum certain 25
Worthless securities, refusal to pay note 260

Novation
Define 120

Opinion 19
Denial of 19
On balance sheet and income statement 194
Qualification or disclaimer, explain circumstances of each 153
Qualified 19
Unqualified, as to accuracy of inventories 62
Unqualified, on statements audited by others 112
Unqualified, on statements failing to disclose material fact 112
Unqualified, on statements prepared by treasurer of company 112
Unqualified, suggest changes in procedure and policy in order to express 112

Original cost
Accounting and regulatory concept of, difference 83
Difficulties and disadvantages of using, in public utility accounting 83

Overhead
Absorption and underabsorption 102
Capacity terms, define and describe differences 222
Sales price per unit, ratio of gross profit 234

Ownership rights
Property, purchased at forced sale and voluntary sale, state difference 119

Partnerships
Acts of partners, without consent of all 257
Audit of incomplete records 46
Balance sheet, prepare 244
Bankruptcy of partner, dissolution 122
Cash payment schedule, profit and loss and taxable income statements, prepare 145
Continuation, in absence of agreement 122
Continuation of, without settlement or liquidation 76
Death of partner, effect on firm 165
Debt, liability of limited partner for 257
Debt, liability of partner for 257
Deceased partner, liability of estate for obligations of firm 122
Deceased partner's right in firm property 165
Dissolution and winding-up, distinguish between 122
Dissolution, schedule of cash payment, realization of assets 147
Distribution of profits or losses 46
Interest allowances 46
Interest always in personal property 76
Interest on advances to firm 165
Interest on capital contribution, in absence of agreement 165
Law of agency under uniform partnership act 76
Liability for obligations before admission 122
Limited, inclusion of general partners in 76
Limited, recognition at common law 76
Losses in liquidation, methods of dividing 216
Natural persons as 76
Note of partner, signed in firm name 28
Note of partner's wife, signed in firm name 257
Partner's compensation for services to firm 165
Receipt as rent by landlord of share of profits, evidence of 76
Rights in specific property 76
Tax return on cash basis 224
Title to real estate, conveyance executed by one or all partners 165
Title to real property in firm name 76
Use of fictitious name 76

Patents
Sale of, transfer of rights, for tax purposes 136

INDEX

Pension plans
  Entries in books to cover cost 220
Personal property
  "Accession" and "confusion" 28
  Liability of hotels and inns for 258
  Partner's interest in partnership 76
  Title to lost property 28
Physicians
  Tax return 80
Plastic products company
  Research costs 34
Pledged bonds
  See Bonds
Pledged property
  Obligation to return identical items 258
Principal and agent
  See Agency
Private carrier
  Define 27
  Distinguish between common carrier and, as to liability 27
Privileged communication 75
Production
  Projected statement of sales, manufacturing cost of sales and gross profit with supporting schedules 192
  Stabilizing, advantages 219
Professional ethics
  Brochure showing advantages of services of new firm 112
  Competitive bidding 112
  Newspaper announcements 112
  Opinion, unqualified, on statements audited by others 112
  Opinion, unqualified, on statements failing to disclose material fact 112
  Opinion, unqualified, on statements prepared by treasurer of company 112
  Practice in corporate form 112
Profit
  Changes, to arrive at corrected net income 91
  Gross, compute 4
Property
  See also Personal Property; Real estate
  Abstract of title, define 168
  Certified balance sheet for real estate company 270
  Community, define 168
  Conveyance of land without access to highway, right of buyer easement 122
  Escrow agent, define 168
  Fixed asset accounts, procedures necessary in auditing 247
  Future goods, sale of, effect of agreement 163
  Goods, define 163
  Joint tenancy, define 168
  Right to recover damages to land 122
  Tenancy at sufferance, define 168
  Tenancy for years, define 168
  Tenancy in common, define 168
  Valuation, state description used to explain capital surplus 270
Proprietorships
  New, prepare balance sheet 244
Public enemies
  Define, as to carriers 27
Public offerings
  Revocation 215
Purchase and sale of apartment house
  Prepare journal entries 45
Purchasing department
  Investigation of, outline program 21
Radio manufacturers
  Reserve for product warranty 100
Real estate
  See also Property
  Advice on sale of property 80
  Allocation of cost of several properties, effects of exchange on taxable income 230
  Apartment houses, prepare journal entries on buyer's and seller's books 45
  Certified balance sheet 270
  Improvements made, not adding to resale value, accounting treatment of expenditure 265
  Items charged or credited to 77
  Right to recover damages to land 122
  Title in firm name, conveyance executed by one or all partners 165
  Title to, in partnership name 76
Receivables
  See also Accounts receivable
  Audit of, criticize completeness or incompleteness of procedures 112
Reconciliations
  Intercompany accounts 184
Records
  Required, failure to keep, responsibility of accountant to client in another state 123
Reports
  See also Statements
  Explain difference as to information in internal and external 84
  Long-form, information included, for credit purposes 206
Research and development
  Capitalization of net operating loss as 85
  Costs, accounting treatment 34
  Miscellaneous income deductions or deferred charges, audit procedures, disclosures, qualifications 252

INDEX

Reserve for product warranty
  Compute balance, prepare working paper schedule 100
Retained earnings
  Consolidated statement 93
Robinson-Patman act
  Regulatory provisions, state nature 123
Royalties
  Due under lease 202
Salaries
  Accrual of, overstated, how shown in statements 128
Sales
  Bulk, define, give purpose and provisions of laws 259
  By description, property in goods passes to buyer when in deliverable state 169
  By sample, implied warranty 169
  Conditional 68
  Conditional, and chattel mortgage, difference between 68
  Contract to sell, property in goods passes to buyer 169
  Goods delivered in larger quantity than buyer agreed to sell, accept or reject 169
  Goods delivered "on sale or return," property passes to buyer 169
  Implied warranties imposed on sellers by Uniform sales act 210
  Legal remedies under Uniform sales act 24
  Loss of lien by seller, lawful possession by buyer 169
  Salesman's duty to account for funds 27
  Salesman's gratuities, required to account to principal 27
  Stoppage in transit 215
  Traveling salesman's authority to collect 27
  Voidable title 169
Savings plan
  Personal, amount available after retirement, compute 96
Scrap
  Engines sold as 21
Service charge
  Cost of handling account, limitations of cost figures obtained 129
Sinking fund
  Reserve, purpose, disposition after bond retirement 266
Social security
  Dismissal payment 30
  Outline of audit program for verification of taxes 18
  Regulatory provisions, state nature of act 124
  Service in employ of family 30
Specialty stores
  Audit 115
Standard costs
  Analysis of labor cost variance 186
  Compute and analyze variances from 44
  Cost sheet from data, prepare 186
Statement of affairs
  See Statements
Statements
  See also Balance sheet; Reports
  Affairs, prepare 50
  Audit of, render opinion as to balance sheet and income statement 194
  Cash flow, decrease in cash 149
  Consistency, explain emphasis on 19
  Consolidated, effect of purchase of equipment from subsidiary on 78
  Consolidated, retained earnings 93
  Consolidated, what eliminating entries are made on worksheet 78
  Consolidating, prepare 43
  Cost and inventory, letter to accompany 106
  Disclosure 19
  Disclosure considered necessary in presentation 93
  Estimated deficiency, prepare 50
  Events subsequent to date of report, opinion, questions on 201
  False registration, damages in civil liability suits under Securities act 212
  False registration, liability of accountants under Securities act 212
  Financial position, criticize 77
  Footnotes, prepare 190
  For credit purposes 154
  Income, acceptability of data contained in, "all-inclusive" and "current operating performance" concepts 172
  Income, in purchase of electric appliance business, prepare from data 2
  Income, presentation of items on 46
  Internal, name two types other than income and balance sheet 84
  Manufacturing, prepare 13
  Methods of disclosure, reasons for alternatives selected 268
  Presentation on auditor's letterhead without comment, opinion, or signature 153
  Sales, manufacturing cost of sales, and gross profits, with supporting schedules 192
  Source and application of funds and working capital changes, prepare from trial balances 236

INDEX

Source and application of funds, decrease in net working capital 149
Source and application of funds, in partnership, prepare 11
Stock dividend, draft note setting forth basis of accounting for 229
Surplus accounts, prepare 229
Unappropriated retained earnings, acceptability of data contained in, "all inclusive" and "current operating performance" concepts 172

Statute of limitations
Define 120
Suit under, period computed 259
Suspension of time period, circumstances causing 259
"Tolling" of, state ways and explain reasoning 259

Steel companies
Inventories 106

Stock
Capital, number of shares issued by company, percentage of control held, compute 235
Cost of common shares, prepare schedule showing 40
Dividend income, prepare schedule showing 40
Gain or loss on sales, prepare schedule showing 40
Resale over purchase price, reflection in retained earnings 34
Subscriptions, before corporate organizations 168
Tax problems in gift of 268

Stockholders
Minority, illegal use of corporate powers, restraint by 73
Minority, suit by 73

Stoppage in transit
Delivery ends right 215
Enforcement of rights after recovery 215
Does not exist against holder of bill of lading in good faith 215
Right of, buyer insolvent 169
Seller liable if acts on mistaken belief as to insolvency 215

Subscriptions
Nature of amount shown as deferred income, explain 269
Portion of income deferred 269

Surety
Liability of, for extension of time 210

Surplus
Analysis of changes made in 93
Capital, description used to explain, in property valuation problem 270
Current fund, composition and significance of amounts 130
Prepare statement for inclusion in annual report 229
Use of term in statements of governmental bodies 130

Tax returns
Consolidated, greater tax than separate returns 136
Consolidated, requirement to file in succeeding years 136
Consolidated versus separate, advantages and disadvantages 217
Husband and wife joint returns, decision to file separate returns 136
Individual 1
Individual, prepare from data, submit schedules and computations 87
Joint, compute liability by various methods 180
Partnership return on cash basis, prepare 224
Physicians 80
Reasons for seeing return for preceding year 80
Sole proprietorship 1

Taxes
See Estate taxes; Income taxes; Social security; Unemployment taxes

Terminology
Balance sheet, change to conform with generally accepted accounting principles 35
Changes in, suggested by American Institute of Accountants 264

Testimony
As to conformity with generally accepted accounting principles 79

Theory of accounts
Questions in 31, 77, 126, 171, 216, 263

Title
Abstract of, define 122
Acquisition of real property in partnership name 76
Passing of, damaged goods in transit 257
Passing of, in goods on approval 73
Search, define 122

Tool manufacturers
Program for substantiating inventory 250

Trial balance
Entries for skeleton ledger "T" accounts taken from 136

Trucking company
Audit, for credit purposes 154

Trumb radio corporation
Reserve for product warranty 100

Unemployment taxes
Amount of yearly tax per employee 30

INDEX

Dismissal payment 30
Outline of audit program for verification of 18
Taxable employers 30
Uniform partnership act
Application of law of agency 76
Uniform sales act
Caveat emptor 24
Goods, define 163
In good faith, thing done honestly, but negligently 163
Unpaid seller's remedies 24
Unilateral mistake
Define, as applied to enforceability of contract 214
Unit costs
Prepare statement 241
Usury
Define 120
Valuation
Bases, to supplement or replace cost, justification for use of 178
Voting trust agreement
Define 73
Wages and hours law
See Fair labor standards act
Warranty
Automobile hire, warranted by bailor 258
Breach of, bailee's remedy 258
Breach of, buyer's remedy 119, 169
Breach of, misrepresentation of goods 213
Breach of, recovery for damages 261
Implied, imposed on sellers by Uniform sales act 210
Implied, usage of trade 169
Waste
Isolating, accounting techniques available in 128
Recognized, measured, analyzed, in accounting procedure 128
Water department
Operating statement, analysis of operating surplus 187
Witness
See Testimony
Working papers
Categories of information 17
Workmen's *compensation*
Farm laborers and domestic servants, included in 212
Payable in employer's negligence, injury self-inflicted, injury while intoxicated 212
Payment to workmen and dependents 212
Worksheet
Prepare, showing adjustments to income statement 37