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Robert L. Kane

Fontaine C. Bradley

American Institute of Accountants

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UNIFORM CPA EXAMINATION · ANSWERS · 1951—1953

UNOFFICIAL ANSWERS

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

MAY 1951 TO NOVEMBER 1953

UNOFFICIAL ANSWERS

..... To The Uniform Certified Public Accountants Examination Of The American Institute Of Accountants

MAY 1951 TO NOVEMBER 1953

by

Robert L. Kane, Jr.

Fontaine C. Bradley

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

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FOREWORD

The text of the Uniform Certified Public Accountant Examinations, prepared by the board of examiners of the American Institute of 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 eighth. 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 1951 to November 1953. 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 and Robert L. Kane, Jr., who have prepared them for publication.

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

June 1954

Contents

UNOFFICIAL ANSWERS TO COMPLETE EXAMINATIONS

Page

May, 1951 ---------- 1
November, 1951 ---------- 36
May, 1952 ---------- 67
November, 1952 ---------- 96
May, 1953 ---------- 129
November, 1953 ---------- 170

INDIVIDUAL SUBJECTS

Accounting Practice—Part I

May, 1951 ---------- 1
November, 1951 ---------- 36
May, 1952 ---------- 67
November, 1952 ---------- 96
May, 1953 ---------- 129
November, 1953 ---------- 170

Accounting Practice—Part II

May, 1951 ---------- 7
November, 1951 ---------- 39
May, 1952 ---------- 74
November, 1952 ---------- 102
May, 1953 ---------- 134
November, 1953 ---------- 175

Theory of Accounts

May, 1951 ---------- 12
November, 1951 ---------- 45
May, 1952 ---------- 77
November, 1952 ---------- 106
May, 1953 ---------- 145
November, 1953 ---------- 182

Auditing

May, 1951 ---------- 21
November, 1951 ---------- 54
May, 1952 ---------- 83
November, 1952 ---------- 114
May, 1953 ---------- 155
November, 1953 ---------- 191

Commercial Law

May, 1951 ---------- 29
November, 1951 ---------- 60
May, 1952 ---------- 89
November, 1952 ---------- 120
May, 1953 ---------- 163
November, 1953 ---------- 200

INDEX ---------- 209

Answers to Examinations, May 1951

Accounting Practice—Part I

May 16, 1951; 1:30 to 6 p.m.

Solution 1 (10 points)

a. *Computation of Book Value of Inventory as of December 31, 1950*

	1948	*1949*	*1950*
Sales	$185,904	$196,603	$203,317
Less—Allowances	3,325	2,402	2,212
Net sales	$182,579	$194,201	$201,105
Cost of goods sold:			
Inventory January 1	$ 35,304	$ 42,380	$ 45,755
Purchases, net of allowances	151,679	156,405	164,418
Total	$186,983	$198,785	$210,173
Inventory December 31	42,380	45,755	51,300
Cost of goods sold	$144,603	$153,030	$158,873*
Gross profit	$ 37,976	$ 41,171	$ 42,232
Rate of gross profit	20.8%	21.2%	21%

Estimated value of assets destroyed:
Inventory under gross profit method—$51,300
Furniture and fixtures at cost less depreciation—$10,570

* Computed

b. Amount due from each company:

Fixtures: In instances where there is total loss, the amount due from insurers is limited to the face of the policies or to the fair value of the property, whichever is less. Since the fixtures are worth $10,570 and are a total loss, the companies owe the face amounts ($8,000) of their policies.

Inventory: The value of the inventory was in excess of the policies, and was totally destroyed; therefore each company will pay the full amount of its policy.

c. Amount due from each company if there is a 50% loss:

Fixtures:

$$\frac{\text{Loss of \$5,285} \times \text{\$8,000 face of policies}}{\text{80\% of value of \$10,570}} = \frac{\$42,280,000}{\$8,456} \text{ or \$5,000 total collectible.}$$

A would pay 2/8 of $5,000 or $1,250; B would pay 3/8 or $1,875 and & L D Company would also pay $1,875.

Inventory:

$$\frac{\text{Loss of \$25,650} \times \text{\$45,000 face of policies}}{\text{80\% of \$51,300}} = \frac{\$1,154,250,000}{\$41,040} = \$28,125$$

Since the insurance is in excess of the 80% requirement the companies would pay the full loss of $25,650. A would pay 4/9 or $11,400; B would pay 3/9 or $8,550 and C would pay 2/9 or $5,700.

Solution 2 (5 points)

a.

Standard production: 200 × 399.5	79,900
Per cent actual of standard production 99,076 ÷ 79,900	124%
Excess production: 124% — 100%	24%
Men's share: ¼ of 24%	12%
Bonus: 12% of $1.25	$.15*
Total amount of bonus: 399.5 hours @ $.15	$59,925

* Per hour

b. Allen:

Day wages:	40 hours @ $1.00	$40.00
Bonus:	40 hours @ $ .15	6.00
	Total wages	$46.00

Knoll:

Day wages: 39.5 hours @ $1.50	$59.25
Bonus: 39.5 hours @ $.15	5.93
Total wages	$65.18

Solution 3 (15 points)

D. P. MANUFACTURING COMPANY

Estimated Gross Profit for 1951 If Product Is Not Changed

Sales (133-1/3% of Cost)	$195,867
Cost of goods sold:	
Material used (1)	$ 37,800
Direct labor (2)	59,400
Overhead:	
Fixed	20,000
Variable (3)	29,700
Total	$146,900
Estimated gross profit	$ 48,967

Computations

(1) *Material Used*

1950 Amount	$ 40,000
5% Price increase	2,000
	$ 42,000
10% Decrease in number of units	4,200
	$ 37,800

Computations (Continued)

(2) *Labor*

1950 Amount	$ 60,000
10% Rate increase	6,000
	$ 66,000
10% Decrease in units	6,600
	$ 59,400

(3) *Variable Overhead*

1950 Amount	$ 30,000
1950 Labor	60,000
Rate	50%
1951 Labor	59,400
1951 Overhead @ 50% rate	$ 29,700

D. P. MANUFACTURING CO.

Estimated Gross Profit for 1951 If Product Is Redesigned

Sales (4)	$253,000
Cost of goods sold:	
Material used (5)	$ 48,279
Direct labor (6)	71,280
Overhead:	
Fixed	20,000
Variable (7)	43,560
Total	$183,119
Estimated gross profit	$ 69,881

Computations

(4) *Sales*

1950 Sales	$200,000
15% Price increase	30,000
10% Volume increase	23,000
	$253,000

(5) *Material Used*

1950 Material @ 1951 prices	$ 42,000
5% Lower average price	(2,100)
10% Increase in number of units	3,990
10% Increase in material per unit	4,389
	$ 48,279

(6) *Direct Labor*

1950 Labor	$ 60,000
20% More per unit	12,000
10% Lower rate	(7,200)
10% More units	6,480
	$ 71,280

(7) *Variable Overhead*

1950 Amount	$ 30,000
20% Increase based on more labor per unit	6,000
10% Increase based on more units	3,600
10% Increase based on price changes	3,960
	$ 43,560

Solution 4 (20 points)

		Debit	*Credit*
(1)	Investments	$ 10,212	
	Cash		$ 10,212
(2)	Cash	5,168	
	Investments		5,000
	Profit on sale of Investments		168
(3)	Cash	247,833	
	Loss on Bad Accounts	665	
	Sales	481	
	Accounts Receivable		248,979
(4)	Accounts Receivable	254,005	
	Sales		254,005
(5)	Cost of Sales	151,914	
	Inventory		151,914
(6)	Obsolete merchandise	1,025	
	Inventory		1,025
(7)	Accounts Payable	556	
	Inventory		556
(8)	Inventory	153,314	
	Accounts Payable		153,314
(9)	Selling Expense	25,348	
	Accounts Payable		25,348
(10)	Executive salaries	15,500	
	Accounts Payable		15,500
(11)	Other Administrative Expense	21,567	
	Accounts Payable		20,594
	Allowance for Depreciation		973
(12)	Fixtures	2,501	
	Accounts Payable		2,501
(13)	Interest Expense	850	
	Accounts Payable		850
(14)	Accounts Payable	211,102	
	Cash		211,102
(15)	Cash	436	
	Allowance for Depreciation	176	
	Loss on Sale of Fixtures	23	
	Fixtures		635
(16)	Bank Loan	10,000	
	Cash		10,000
(17)	Tax Expense	3,700	
	Accrued Income Taxes		3,700

	Debit	Credit
(18) Accrued Income Taxes	5,658	
Cash		5,658
(19) Surplus	10,000	
Cash		10,000

Cash

Bal. 7-1-50	$ 21,849	(1)	$ 10,212
(2)	5,168	(14)	211,102
(3)	247,833	(16)	10,000
(15)	436*	(18)	5,658
		(19)	10,000
	$275,286		$246,972

*The total debits to "cash" exceed the book total by $270, therefore one of the debits is smaller than shown here by the $270 which the books show as "unlocated difference."

Investments

Bal. 7-1-50	$30,500	(2)	$5,000
(1)	10,212		
	$40,712		

Receivables

Bal. 7-1-50	$ 47,420	(3)	$248,979
(4)	254,005		
	$301,425		

Bad Debts

(3)	$665		

Inventory

Bal. 7-1-50	$ 55,542	(5)	$151,914
(8)	153,314	(6)	1,025
		(7)	556
	$208,856		$153,495

Office Furniture & Fixtures

Bal. 7-1-50	$ 8,663	(15)	$635
(12)	2,501		
	$11,164		

Allowance for Depreciation

(15)	$176	Bal.7-1-50	$4,967
		(11)	973
			$5,940

Loss on Sale of Fixtures

(15)	$23		

Bank Loans

(16)	$10,000	Bal. 7-1-50	$30,000

Accrued Income Tax

(18)	$5,658	Bal. 7-1-50	$ 7,350
		(17)	3,700
			$11,050

Tax Expense

(17)	$3,700		

Profit on Investments

		(2)	$168

Sales

(3)	$481	(4)	$254,005

Cost of Sales

(5)	$151,914		

Obsolete Merchandise

(6)	$1,025		

Selling Expense

(9)	$25,348		

Executive Salaries

(10)	$15,500		

Other Administrative Expense

(11)	$21,567		

Interest Expense

(13)	$850		

Surplus

(19)	$10,000	Bal. 7-1-50	$55,778

Accounts Payable

(7)	$ 556	Bal. 7-1-50	$ 15,879
(14)	211,102	(8)	153,314
		(9)	25,348
		(10)	15,500
		(11)	20,594
		(12)	2,501
		(13)	850
	$211,658		$233,986

Capital Stock

		Bal. 7-1-50	$50,000

Location of error: The posting of transactions as they appear to have occurred leaves the cash account with total debits of $275,286 instead of $275,016 and with a balance of $28,314. However, the company's books as kept show a cash balance of $28,044 which has been verified. The difference of $270 very likely arises from the same error which caused the "unlocated difference" of $270 in the trial balance.

The fact that $270 is evenly divisible by nine indicates the possibility of a transposition. Since the $270 discrepancy in the cash account in the solution and the bookkeeper's cash account appears on the debit side of the account the error should be found in one of the entries which included debits to cash.

In examining the debits in the cash account we can presume that the opening balance of $21,849 is correct since it was included in the opening trial balance which showed no discrepancies. By looking at entries 2 and 3 we see that neither entry contains a figure which could include a transposition error of $270 if we assume that there were no other errors. Entry number 15, however, contains a credit of $635 to the Office Furniture & Fixtures account. This entry might well be where the $270 transposition error occurred.

If the $635 credit to Office Furniture & Fixtures had been correct, the entry for the sale would have been:

Dr.	Cash	$436	
	Reserve for Depreciation	176	
	Loss on sale of Furniture & Fixtures	23	
Cr.	Office Furniture & Fixtures		$635

Since this overstates cash by $270, the amount which was received, and which the bookkeeper posted to the account, must have been $166 ($436 — $270). The correct entry would have been:

Dr.	Cash	$166	
	Reserve for Depreciation	176	
	Loss on sale of Furniture & Fixtures	23	
Cr.	Office Furniture & Fixtures		$365

It appears that the bookkeeper made a transposition error and posted a credit of $635 instead of $365 to Office Furniture & Fixtures.

Further evidence can be gathered from an examination of the depreciation entries for the period. Furniture and Fixtures appears to be the only account subject to depreciation. Since the Reserve for Depreciation was credited with $973 for the six months, and the Furniture & Fixtures account ranged from an opening balance of $8,663 to a closing balance of slightly over $10,000, the depreciation charge for the period appears to have been something like 10% for the six months or 20% per year.

Assuming three months (half of the period) depreciation for items sold or purchased during the period, the following computation for depreciations seems feasible:

Office Furniture & Fixtures Account:

July 1, 1950 Balance....	$ 8,663	
3 months @ 20% per yr.		$433
Addition during period...	2,501	
	$11,164	
Sale of fixtures (assuming error in this item)....	365	
	$10,799	
3 months depreciation @ 20% per yr..........		540
Depreciation for the period		$973
Credit to Reserve for depreciation for the period ..		$973

Accounting Practice—Part II

May 17, 1951; 1:30 to 6 p.m.

No. 1 (10 points)

a.
1. (a) True
2. (a) True
3. (b) False
4. (a) True
5. (a) True
6. (b) False
7. (a) True
8. (a) True
9. (a) True
10. (b) False

b.
1. (d) $3,000
2. (a) $1,000
3. (a) $800
4. (b) $3,000
5. (b) $1,000
6. (1) (d) 0
   (2) (c) $1,000

c.
1. (b)
2. (b)
3. (b)
4. (a)
5. (a)
6. (a)
7. (a)
8. (b)
9. (d)
10. (d)
11. (c)
12. (d)
13. (c)
14. (c)
15. (c)

No. 2 (25 points)

SCHEDULE OF DISTRIBUTION OF COMMON STOCK

	Total	*Waverly Hotel*	*Rustic Camps*	*Lakeview Cottages*
Net income reported	$10,075	$3,379	$7,624	($ 928)
Adjustment of depreciation	(2,954)	(3,010)	112	(56)
Adjustment for salaries	100	600	(3,000)	2,500
Deferred maintenance	(500)	(500)	. . .	. . .
	$ 6,721	$ 469 (f)	$4,736	$1,516
Common Stock—shares	1,000	70	705	225

COMPUTATION OF DEPRECIATION ADJUSTMENT

	Depreciation per Books	*Computation*	*Adjusted Depreciation*	*Debit Adjustment*
Waverly Hotel	$1,590	4% of $40,000	$1,600	
		10% of 30,000	3,000	$3,010
Rustic Camps	850	4% of $10,200	408	
		10% of 3,300	330	(112)
Lakeview Cottages	2,300	4% of $41,000	1,656	
		10% of 7,000	700	56

Note (f): The $600 of interest included in the book deductions could be added back to income since it is not a logical factor in making the computation of adjusted income for the purpose of distributing stock. However, the problem statement does not appear to call for such an adjustment.

WORKSHEET FOR THE WAVERLY RESORTS, INC.

	October 1, 1950 Transactions		October 1 to December 31 Transactions		Three Months Income Statement		Balance-Sheet December 31, 1950	
Current assets	(1) $ 10,000		(4) $ 6,500.00	(5) $ 1,800.00				
	(3) 5,000		(8) 550.00	(6) 1,200.00				
				(9) 800.00				
				(10) 2,750.00			$ 15,500	
Land	(1) 10,000							
	(2) 1,500							
	(3) 1,600						13,100	
Buildings	(1) 40,000		(7) 4,500.00(c)					
	(2) 10,200							
	(3) 41,400						96,100	
Equipment	(1) 30,000		(5) 900.00					
	(2) 3,300		(6) 1,500.00	(8) 1,700.00				
	(3) 7,000						41,000	
Excess of par value of stock issued over values assignable to tangible property received	(2) 10,000	(1) $ 7,500(a)					2,500	
Reserve for depreciation			(8) 42.50	(11) 916.00				
				(12) 1,007.50				$ 1,881
Current liabilities				(6) 300.00				
				(7) 4,500.00				
				(9) 400.00				
				(10) 250.00				5,450
Bonds payable		(1) 50,000						50,000
Preferred stock		(1) 32,500						
		(2) 25,000						
		(3) 55,000						112,500
Common stock	Memo for shares issued (e)							
Income from guests				(4) 6,500.00		$6,500		
Deferred alteration expense			(5) 900.00(b)				900	
Loss on sale of assets			(8) 1,107.50(b)		$1,107.50			
Salaries			(9) 1,200.00		1,200.00			
Miscellaneous expenses			(10) 3,000.00		3,000.00			
Depreciation expense			(11) 916.00		916.00			
			(12) 1,007.50		1,007.50			
Net Loss						731	731	
	$170,000	$170,000	$22,123.50	$22,123.50	$7,231.00	$7,231	$169,831	$169,831

Notes: a. This amount might be credited to the Buildings account since it appears that earnings do not support the appraisal values. However, since the series of transactions produce a net debit, offsetting the $10,000 and the $7,500 appears to be reasonable.
b. If provision had been made at the time of purchase of the assets to cover these items, the debits would be against such provision. However, unless it is assumed that the preferred stock was issued at a discount, there is no alternative except to defer or expense these items. Loss on sale of assets would not be deferred. It has been charged to expense.
c. It is a general rule that costs incurred in rehabilitating a fixed asset knowingly acquired in a run-down condition will be capitalized. Since at time of acquisition it was known that the hotel had not been properly maintained, and presumably the price allowed considered that fact, the capitalization of the $4,500 appears to be required in this instance.
d. Interest of $500 on bonds should be accrued unless the amount is included in other expenses of $3,000.
e. In some states, stock must have some assigned value. In those states a nominal value would be assigned and probably added to the $2,500 arising from transactions (1) and (2).

No. 3 (15 points)

LIBRARY ENDOWMENT FUNDS

Balance-Sheets

June 30, 1951

EXPENDABLE

Cash		$ 510	
Estimated revenue	$2,000		
Unexpended appropriations	$2,050	(50)	(1)
		$ 460	
Reserve for Encumbrances		$ 70	
Accrued expenses		90	
Unappropriated surplus		300	
		$ 460	

NON-EXPENDABLE

Cash	$ 4,275	
Investments:		
Bonds	52,000	
Stocks	52,005	
Land and Building	22,500	(4)
	$130,780	
Fund Principal	$130,780	(3)
	$130,780	

ANALYSIS OF SURPLUS
Six months Ended June 30, 1951
Expendable Fund

Net income		$ 220
Excess of estimated revenue over actual revenue		2,000
		$2,220
Deduct:		
Encumbrances	$ 70	
Excess of appropriations over expenditures and encumbrances	2,050	
		$2,120
		$ 100
Receipt of contribution for current use		200
Unappropriated surplus June 30, 1951		$ 300

STATEMENT OF INCOME AND EXPENSE
Expendable Fund
Six Months Ended June 30, 1951

Interest and dividends		$3,180	(6)
Fines		20	
Total		$3,200	
Expenses:			
Salaries	$1,500		
Purchase of books and magazines	1,130		
Miscellaneous expenses	350	2,980	
Net income		$ 220	

ANALYSIS OF CHANGES IN FUND PRINCIPAL

October 1, 1950, to June 30, 1951

NON-EXPENDABLE FUND

Contribution from Estate of James Jones		$135,300
Gain on sale of bonds		270 (3)
Total		$135,570
Deduct:		
Taxes accrued on property	$ 200 (2)	
Loss on sale of stock	375 (3)	
Payment of authorized expenditures for equipment, books and alteration	4,215 (5)	4,790
Balance June 30, 1951		$130,780

Notes: 1. Appropriations might be increased $200 as a result of the receipt of $200 to be used in purchasing books if the trustees indicated that this was their intent. If that were done, surplus would be reduced to $100.
2. The taxes on the real estate had accrued at the rate of death, therefore they have been charged to fund principal.
3. Gain and loss on sale of securities have been treated as applicable to principal in accordance with the usual rule for trusts.
4. No depreciation is ordinarily charged on an asset which was included in original trust property. Depreciation is not taken on equipment purchased out of the fund principal because of the apparent intent for the $5,000 to be considered a reduction of principal.
5. Under provision of the will, it appears that these items are to be treated as reductions of principal; however, they might be set up as assets and written off over the period for which the benefit is expected to be received.
6. Accrual of interest is not possible from the given data and is not a requirement in accounting for an expendable fund even where the information is available.

No. 4 (15 points)

STATEMENT OF PARTNERS' CAPITAL ACCOUNTS

	A		*B*		*C*		*D*		*E*	
	Amount	*P&L %*	*Amount*	*P&L %*	*Amount*	*P&L %*	*Amount*	*P&L %*	*Amount*	*P&L %*
January 1, 1948, Investment	$25,000	50	$12,500	25	$12,500	25				
January 1, 1949, Adjustment	(2,500)		(12,500)		5,000		$10,000			
January 1, 1949, Balance	$22,500	45	$ ..		$17,500	35	$10,000	20		
January 1, 1950 Adjustment	5,000		..		(17,500)		5,000		$7,500	
January 1, 1949, Balance	$27,500	55	$ ..		$ ..		$15,000	30	$7,500	15

Debit items are indicated by parentheses.

STATEMENT OF PARTNERS' DRAWING ACCOUNTS

	Total	*A*	*B*	*C*	*D*	*E*
1948 Fees received in 1948	($ 80,000)	($40,000)	($20,000)	(20,000)		
1948 Expenses	70,000	35,000	17,500	17,500		
1948 Drawings	52,000	10,500	27,750	13,750		
Balance Dec. 31, 1948	$ 42,000	$ 5,500	$25,250	$11,250		
January 1, 1949, capital transfers	...	(2,500)	(12,500)	5,000	$10,000	
Drawings from capital transfers	15,000	2,500	12,500	...	...	
1948 Fees collected in 1949	(145,000)	(72,500)	(36,250)	(36,250)	...	
1948 Fees received in 1949	(40,000)	(18,000)	...	(14,000)	(8,000)	
1949 Expenses	80,000	36,000	...	28,000	16,000	
Guarantee to D	...	10,125	...	7,875	(18,000)	
1949 Drawings	56,750	40,000	4,750	5,000	7,000	
Balance Dec. 31, 1949	$ 8,750	$ 1,125	($ 6,250)	$ 6,875	$ 7,000	
January 1, 1950, capital transfers	...	5,000	...	(17,500)	5,000	$ 7,500
Drawings from capital transfers	17,500	...	...	17,500	...	...
1949 Fees collected in 1950	(50,000)	(28,125)	...	(21,875)	...	...
1950 Fees collected in 1950	(70,000)	(38,500)	...	...	(21,000)	(10,500)
1950 Expenses	90,000	49,500	...	...	27,000	13,500
1950 Drawings	37,500	10,000	5,000	15,000	2,500	5,000
Balance Dec. 31, 1950	$ 33,750	($ 1,000)	($ 1,250)	$ ...	$20,500	$15,500

Credit items are indicated by parentheses.

Theory of Accounts

May 17, 1951; 9 a.m. to 12:30 p.m.

Group I

No. 1 (12 points)

a. The principal difference in the system described and the usual system is the assignment of administrative and selling costs to cost of goods manufactured and to cost of goods sold and inventory.

In the usual system for manufacturing enterprises, the cost of goods manufactured includes material, labor and factory expenses. Factory expenses may or may not include all factory administrative expenses. General administrative expenses are not charged to production nor are selling expenses but both are treated as costs of the period in which they are incurred.

The H Manufacturing Company will show a higher valuation than if it followed the usual system. This results in a larger total of earnings over the years to the extent administrative and selling expenses are included in closing inventory. The difference is significant chiefly as to work-in-process. Except for technicalities or conventional practices there would be no finished goods inventory and sales would be recorded on completion of the goods. If the manufacturing process is short, and the volume of business is steady, net income for each year will be approximately the same as under the usual system except in the first and last years.

b. The system of the H Manufacturing Company may be criticized on the following grounds:

1. Regardless of its merits, it is an unconventional system.

2. The system involves arbitrary or estimated allocations. Indirect factory expenses and administrative expenses are often in the nature of fixed or standby costs which do not vary with volume of production. They should therefore be charged to the accounting period in which they were incurred. There is a serious question as to the significance and reasonableness of the allocations to jobs on the basis of direct labor hours. Labor hours, or any other single basis, may be a poor measure of effort and cost expended either in selling or in administering a business.

This criticism, it should be noted, applies to the conventional inclusion of indirect factory costs as well as to the unconventional inclusion of general administrative costs and selling costs.

3. The system does not give useful results, at least for cost-control purposes. Computed production costs and inventory values will vary markedly with changes in the volume of production. In a low-volume period, each job order might show a loss, whereas the loss would be better attributable to the lack of orders and the low volume of activity. Inventory values might be in excess of contract selling prices, necessitating write-downs. The resulting statements would hardly be more informative for many purposes than conventional statements.

4. The system may not go far enough in matching cost and revenue (effort and accomplishment) if that is its purpose. Selling costs incurred to obtain future orders are charged to current production. Selling costs and administrative costs

should be charged against the job orders for which they were incurred rather than spread over the jobs currently in production. The system used by H Manufacturing Company defers selling and administrative costs only to the extent they are included in inventory.

c. The system of the H Manufacturing Company may be justified as follows:

1. It results in a better matching of cost and revenue than conventional methods. At least some administrative and selling costs are deferred under the system.

2. In theory, all costs rank alike and there is no preferential order of cost recovery. The president's salary and a plant superintendent's salary must both be recovered through sales. Both are indirect costs of production.

3. Selling prices are set by contract and there is certainty as to the amount of cost recovery. No question of conservatism is involved. All job costs should be matched against the selling price.

4. It is a useful system in negotiating or bidding on contracts. All job costs would be considered in setting a contract price, not just production costs.

5. It is a useful system in allocating costs between government and civilian orders. The allocation would seem to be reasonably equitable.

6. Arguments against the system apply equally to many conventional or accepted systems. Under all conventional systems, production costs and inventory values will vary somewhat with changes in the volume of production. Conventional systems also rely on estimates or arbitrary apportionments. Depreciation of plant and equipment under a straight-line method is as much a "period" cost as officers' salaries.

7. In some job order fields, salesmen are engineers or production men. Their surveys, plans, and estimates are really production expenses and should be recognized as such, which is done to some extent under this method.

8. A company operating on the basis which is followed by this one, is likely to have very low costs for sales and administrative effort. The percentage such costs represent of the total cost may be much smaller than for the usual business.

9. The sequence of cost incurrence for this business may be different than that for many business-nesses. In a business manufacturing for stock, sales effort is expended after the goods are produced in order to sell them. Here selling is in advance of production.

No. 2 (12 points)

The suggestion that depreciation rates should be doubled because of the rate of plant operation has doubled is probably unsound. However, it is probable that there should be some increase in rates if the operations are expected to continue at the accelerated rate.

Depreciation does not result from wear and tear due to use. If it did do so, the rates might be doubled. Generally, depreciation rates take into account several factors that cause assets finally to lose their value. There are physical factors such as age (decrepitude) and the effect of the elements as well as wear and tear from use; functional factors such as obsolescence, supersession or inadequacy;

and chance factors such as accidents of various types. The part that each of these factors has in the process of setting depreciation rates in any particular instance may be impossible to determine. Probably in most instances all such factors are in part considered because rates are frequently based on past experience and these factors also have been effective in the past.

When the amount of usage is increased, not all of these factors will vary to the same extent. Obsolescence and supersession might not be a function of usage in any way, whereas wear and tear undoubtedly would vary rather directly with usage. Related closely to wear is the maintenance policy followed by the company. While maintenance can offset a considerable portion of normal wear, the operation of a plant on a multi-shift basis may interfere with usual maintenance.

The question of what rate to use in computing accelerated depreciation can be decided reasonably only after considering all of the factors which are taken into account in a rate and after considering the maintenance policy of the company. Probably a rate of 200 per cent of the normal rate would be found to be excessive in view of the nature of some of the elements included in the depreciation provision.

No. 3 (8 points)

The use of a completed contract basis is an accepted method of accounting for a going concern but would not be useful for a business that is liquidating by sale of its assets.

If the proposal is put into effect, none of the profit earned on the ten contracts will appear in the partnership records. All of it will be assigned to the new corporation. This result will not reflect what has actually happened, and is, therefore, not acceptable. Approximately 80 per cent of the profits, estimated if necessary, should be assigned to the partnership and the remainder to the new corporation.

This result should follow even though both the partnership and its successor corporation follow consistently the "completed contracts" basis of accounting for all jobs *started and finished* by each. The usual justification for the "completed contracts" basis is that it is a conservative method which reflects no profit until all work is done. As long as the method is followed consistently in any given business, all profits (or losses) will ultimately be assigned to the concern on the basis of realization; but, where the accounting entity changes, as in the instant case, its application will result in a misstatement of final operating results. Each of the business entities has to deal with these ten contracts which are not both started and finished by either business.

Also, the question does not indicate the profit-sharing interests of the partners in the partnership or their respective stockholdings in the corporation. Any difference in their rights to profits in the corporation obviously would result in an unfair division of the portion of the profit earned prior to January 1, 1951. This is particularly likely to occur if the partnership profit ratios differed from the capital ratios and the partners received capital stock in their capital ratios.

No. 4 (8 points)

Accounting records kept under the double-entry system do have certain attributes which make them superior to incomplete records such as those of Mr. Friend. A double-entry system emphasizes the exchange elements in each transaction—what the British "Accountant" calls the giving and receiving. In all transactions, there is a change in one or more balance-sheet accounts. In those affecting balance-sheet accounts only, there is a shift in composition of assets and equities; in those affecting both balance-sheet and income accounts, there is a change in position accompanied by a record of the type of activity which occasioned that change. In addition to this emphasis on a different point of view, double entry is more easily checked for accuracy, and inaccuracies of certain types are more likely to be noticed and corrected. Preparation of various financial statements is simplified where a double-entry system is used. A double-entry record is more likely to provide information in a permanent form and therefore be available and acceptable in litigation or in settling controversies. Its very nature lends itself more readily to preservation and acceptability as evidence.

However, the double-entry procedure does require more records, more time, and more skill in bookkeeping than are required by the records now kept by Mr. Friend. If his present records appear to be serving his needs, there may not be any net benefit to him from making a change so long as his business operations continue in the same pattern as they are at present.

No. 5 (10 points)

The thinking of accountants as to what is conservative has been influenced by the changing emphasis which accountants have placed on the balance-sheet and the income statement. When the primary emphasis was on the balance-sheet, accountants sometimes felt justified in following many procedures which tended to reduce the total of assets and the corresponding capital balance. Rules such as that advocating the anticipation of no profits but the making of provision for all losses were construed to allow understatement of assets.

As the importance of the income statement was more widely recognized, it became apparent to accountants that ultra-conservatism as to balance-sheet accounts, might result finally in the lack of conservatism in the income statement.

In the first year of a concern's operations, it is clearly possible to be ultra-conservative by appropriate understatement of assets (e.g., inventories, prepaid expenses, liberal depreciation on plant and equipment, etc.), or overstatement of debts (e.g., liberal estimate of tax liabilities, etc.).

Over a short number of years, it is more difficult, but still possible, to be consistently conservative in the same sense by *additional* understatements of assets and overstatements of debts. Over a considerable number of years, however, it is manifestly impossible to continue to be conservative both with respect to the balance-sheet and to the income statement, because the required understatement of assets and overstatement of debts reaches definite limits. A building having a 40-year life may be depreciated on the books in 20 years. As a result, assets and net worth will be "conservative"; so will net profits, as reported for 20 years,

because of the substantial depreciation charge. However, in the second 20 years, no depreciation can be recorded, thereby overstating periodic profits. The balance-sheet will continue to be "conservative," but less so as each year passes.

However, if conservatism is considered from the point of view of both statements, it becomes merely a policy of selecting from the permissible alternatives, the procedure which will tend to understate rather than overstate assets. Since it involves making use of the alternative which produces the lowest income and lowest asset value only in instances where because of uncertainty, several procedures are possible, it is unlikely to produce harmful variations in income. However, it is never possible to be conservative in the income statements over a number of years if all transactions affecting the final income of a business are reflected in the income accounts. A reduction in reported income in any one year as a result of a conservative practice followed by the business will affect some future income accounts in a "nonconservative" manner.

Group II

No. 6 (12½ points)

a. Current liabilities are those which reasonably may be expected to require the use of existing current assets in their liquidation. A fair assumption would be that the stockholders had substantial investments which had been jeopardized by insufficient working capital and inability to obtain outside credit on a satisfactory basis. The loans were made to increase working capital and repayment was not expected to be by use of existing current assets. The "voting" arrangement strengthens this assumption. It was apparently intended to prevent a small group of the stockholder-lenders from pushing their claims against the interest of the corporation, the other stockholders, and the outside current creditors.

The balance-sheet should be a statement of useful financial information and not a bare recital of legal facts. Since the working capital section of the balance-sheet is of particular interest to creditors, their use of the balance-sheet must be considered in arriving at a decision as to the classification of these loans. If the stockholders do not intend, and could not afford, to push their claims currently, a more informative balance-sheet would result from showing the notes "below the line" with full disclosure of their terms. Accountants do give effect to "intent" in the classification of balance-sheet items.

If the notes are subordinated to the claims of other creditors by agreement, the fact of subordination should be disclosed along with the other terms of the note.

b. A balance-sheet includes expressions of estimates and opinions, which should be arrived at only after careful consideration of the available evidence. Since the balance-sheet usually is prepared some time after the balance-sheet date, information as to events subsequent to the balance-sheet date should be used in arriving at these estimates and opinions. For example, knowledge of subsequent collections is obviously useful in estimating an allowance for uncollectible receivables.

In this case, it is clear that liquidation of the note will not require the use of existing current assets. The note should, therefore, be excluded from current liabilities. The balance-sheet would disclose that the note has been discharged by issuance of preferred stock subsequent to the balance-sheet date. This is an instance in which subsequent events affect balance-sheet classification.

c. Rent collected in advance is frequently called deferred income. It is almost income, and as time passes it will become income. The problem is one of allocating the income to the proper period. From this point of view, it should be shown on the balance-sheet under a separate caption between the liabilities and the net worth section. It is not a liability since as time passes it will slide down into earned surplus which is not what happens to liabilities.

Another viewpoint is that when rent is collected in advance an obligation has been incurred to render service. Whether or not this obligation is to be classified as a current liability is then decided by the conventional tests. A liability is usually classified as current if its liquidation requires the use of existing current assets. The obligation to render service when rent is collected in advance is liquidated by the use of a fixed asset. Therefore, the obligation should not be shown as a current liability.

It is true that frequently the obligation involves more than providing the use of a fixed asset. Supplementary services such as providing heat or elevator operators may be called for. When an account is of a mixed nature, the general accounting rule is to classify the account according to the nature of its predominant element. If providing the use of a fixed asset is the predominant element, the obligation would not be shown as a current liability.

No. 7 (12½ points)

In order properly to advise the directors, additional information should be available as to the policy or intentions in regard to the financing of the replacement of the club house at the end of the fifty-year period.

The inclusion in the budget of only the $2,000 of depreciation would put the club on a regular business-like operation basis. The $2,000 annual redemption of bonds, could then be met without further budgetary provision since the depreciation of $2,000, while covered by the income from dues and fees, does not represent an expenditure and funds of the required amount would, therefore be available. At the end of the fifty-year period, the bonds would be retired, the club house would be completely depreciated and the construction of a new building would require another bond issue or some other source of funds.

The inclusion in the budget of only the bond retirement provision would have the same financial effect as the inclusion of depreciation, but would result in an abnormal accounting situation. At the end of the fifty-year period, the bonds would be retired, the club house would still be on the books at $100,000, and this would be offset by a surplus item of the same amount. Upon retirement or replacement of the building, one balance would be canceled off against the other. Again, new financing would have to be found for a new club house.

The third alternative is to include both the bond retirement and the depreciation allowance in the annual budget. This would require higher annual dues or fees

to the extent of $2,000. At the end of the fifty-year period, the bonds would be retired, the building would be fully depreciated, the $100,000 would be available toward the financing of a new building. The present generation of members would in a sense, pay for two buildings, but the club would be out of debt unless the new club house cost more than $100,000.

While either of the first two alternatives would produce the funds needed to retire the bonds, a budget for a club is frequently a "cash budget." Depreciation is not included in a cash budget and the directors may find it easier to explain the inclusion of the $2,000 as funds required for bond retirement rather than for depreciation. Depreciation still might be reflected in the income and expense statement if the club wishes to put its accounts on a commercial basis.

The directors must decide which of these results they wish to achieve.

No. 8 (12½ points)

The ordinary balance-sheet and income statement are intended to provide information as to financial position and results of operation of a business in accordance with several assumptions which are made in preparing the statements. From the standpoint of the criticisms made, the most important of these assumptions are that cost less appropriate amortization of cost, measures value and that a business may be assumed to be going to continue operations indefinitely into the future. Accounting statements are usually prepared on the theory that a sale or some other definite event is essential before revenue is recognized. Basically we find that a balance-sheet on the asset side contains a presentation of the amounts of cost incurred which can be presumed to benefit future periods. An income statement presents the amount of revenue recognized as having been realized during the period, less the portion of all costs incurred which does not appear to be fairly deferable to future periods.

The income statement is primarily a measure of what has been earned and not a measure of "earning power." For fixed assets, the balance-sheet is primarily a measure of accountability for expenditures, showing acquisition costs less costs allocated to past operations. This measure of accountability may be quite different from "true value."

To increase its usefulness as one element in judging earning power, the income statement is prepared with a distinction between operating and nonoperating items. For the same reason, certain items may be eliminated from the income statement and shown in the statement of surplus. However, the effect of nonrecurring and nonoperating transactions is not entirely eliminated.

Information revealed by a series of income statements is more significant in judging earning power than information revealed by a single income statement. The income of a business may follow or even exaggerate the ups and downs of the business cycle and, therefore, the income of any single year will not represent earning power. Changes in law, such as the prohibition amendment to the Constitution, or local zoning ordinances, may result in a marked change in the earning power of a business. Likewise, changes in public taste, development of new products, appearance of new competition, acquisition of subsidiaries, changes in management and the like, all may change earning power and yet not be clearly

reflected, if reflected at all, in a single income statement.

The accounting use of historical rather than current dollars in measuring depreciation and cost of goods sold may result in distorting any view of earning power obtained from a single income statement.

In regard to fixed assets, it can be said that their value to a going concern is usually dependent upon the earning power of the business. Such a value is not necessarily the same as liquidation value, cost, cost less amortization, replacement value, or any other kind of value. The phrase "true value" has no definite connotation.

Occasionally, appraisal values are set up when cost less amortization valuation has lost its significance as a measure of accountability. This loss of significance may have resulted from a change in the price level, discovery of valuable natural resources, depressed earnings, etc. Such use of appraisal value may result in the statement of fixed assets at a closer approximation to their "true value." In general, however, the appraisal values are recorded to obtain more significant allocations to the income statement rather than to show "true value" on the balance-sheet.

No. 9 (12½ points)

a. This does not appear to be desirable practice. The stock of P owned by its subsidiary might better be shown as a deduction from the capital and surplus section, since it is held within the consolidated entity. The ownership of such stock might create a legal restriction of consolidated earned surplus in the amount of the cost of the stock to the subsidiary, and if so, such restriction should be disclosed. Even if there is no legal restriction, the treatment of the stock as an investment does not seem justified. Elimination of the stock in question in the preparation of the consolidated statement also is accepted treatment. Perhaps such elimination can be considered as required if the amount is material.

b. The showing of dividends received from the subsidiary as nonoperating income is acceptable procedure on the statement of the parent. Income from an investment in stock of a subsidiary may be taken up by the parent as earned, in which case, dividends received are credited to the investment account; or income may be taken up as dividends are declared, in which case, the credit is to income. In either case, the amount of income recorded is properly classified as nonoperating. Only where dividends are paid out of surplus of the subsidiary at date of acquisition may there be objection to treating such dividends as income to the parent.

c. A consolidated balance-sheet should show only the net amount of dividends payable to interests outside the consolidated entities. The amount due on the stock of P held by S should be subtracted from the total declared amount and the corresponding receivable on the books of S should be eliminated.

No. 10 (12½ points)

a. There are many dates or periods which might be considered to be useful in determining the amount that should be accrued for property taxes. Taxes might be considered to accrue for the year starting with the assessment or lien date

or for the year ending with the assessment or lien date. Taxes might also be assumed to be for the year shown on the tax bill or for the current fiscal year of the taxing authority which includes the date on the bill. Property taxes might also be spread over the taxpayer's fiscal year (or calendar year) which includes the assessment or lien date or which includes the date on the bill. There is not any general treatment accepted to the exclusion of other possible treatments. A business should be consistent from year to year in its treatment of property tax accrual in order to charge a reasonable amount against the income of every year. The Committee on Accounting Procedure of the AIA, suggested that "As a general proposition it would appear that the most acceptable basis of providing for property taxes is for the company to accrue such taxes on its books monthly during the fiscal period of the taxing authority for which they are levied." This procedure might require making estimates at certain times of the probable tax, but such estimates are likely to be reasonably accurate.

b. In income-tax accounting, the rule is that property taxes accrue when all of the events have occurred which fix the amount of the tax and determine the liability of the taxpayer. Ordinarily the ownership of the property on the assessment or on the lien date is the last of the events which will occur.

c. Even though a different period is used, there will be no adjustment unless the amount of the tax varies from year to year. If there is such a variation, the reported net income on the return would be different from that on the books. To the extent that the taxes were in administrative and selling expense, the full difference in taxes would be reflected in a difference in net income. If the taxes are on factory property and equipment, cost of goods manufactured would be affected. A portion of the change might go into inventories, with the remainder going to cost of goods sold and finally to net profit. A reconciliation of the inventories per return and per books, and of the net profit per return and per books would be needed.

Auditing

May 18, 1951; 1:30 to 5 p.m.

No. 1 (10 points)

The proposal for the limitation of procedure is not justified by the stated facts. Although the transfer agent and the registrar know the number of shares issued, they do not necessarily know the number of shares outstanding. Furthermore, the audit of capital stock includes more than determining the number of shares outstanding. For example, the auditor must determine what authorizations exist for the issuance of shares, what assets were received in payment of shares, how the transactions were recorded, and what subscription contracts have been entered into. Confirmation from the registrar could not help in determining these things.

In addition to confirmation from the registrar, the audit of capital stock might include the following procedures for which the purposes are briefly indicated:

1. Examine the corporation charter—to determine the number of shares authorized and the special provisions relating to each class of stock if more than one class is authorized.

2. Examine minutes of stockholders' and directors' meetings—to determine authorization for appointments of the registrar and the transfer agent; to determine authorization for the issuance or re-acquisition of shares.

3. Examine provisions relating to capital stock in the corporation law of the state of incorporation—to determine any special provisions such as, for example, those relating to the issuance of no-par stock.

4. Analyze the capital stock accounts—to obtain an orderly picture of stock transactions for use as a guide to other auditing procedures and as a permanent record.

5. Trace the consideration received for capital stock into the records—to determine what consideration has been received and how it has been recorded.

6. Examine and schedule treasury stock and review entries for treasury stock—to determine the existence of treasury stock, as authorized, and to determine that a proper record has been made.

7. Review registrar's invoices and cash disbursements—to determine that original issue taxes have been paid.

8. Compare dividends with stock outstanding at dividend dates—to determine that dividends have been properly paid and also to substantiate the stock outstanding.

9. Review subscription and option contracts, etc.—to determine the facts in regard to subscriptions and options and to determine that these facts have been properly recorded and that they are adequately disclosed.

No. 2 (10 points)

a. In this situation the major possibilities of fraud or error include: Holding the cash book open after the year end (perhaps to accomplish lapping), making a fictitious entry in the reconciliation or in both the reconciliation and the cash book, and kiting in connection with a transfer of funds from one bank to another.

b. 1. Review and test internal control over cash receipts. Determine if all receipts are deposited intact each day. If an independent list of cash receipts is prepared, check it against the cash receipts book for a few days prior to and subsequent to the balance-sheet date.

2. Count undeposited cash on the balance-sheet date. If material in amount, accompany the messenger to the bank and witness the deposit. In any event, obtain the following month's statement, or a cut-off statement, directly from the bank. Trace the deposit in transit into this statement and determine that the deposit date is reasonable.

3. Trace cash receipts to the accounts receivable ledger. Confirm accounts receivable.

4. Trace interbank transfers, and prepare reconciliations for all bank accounts at the cut-off date paying particular attention to dates when comparing cancelled checks with the cash book entries.

5. If the deposit in transit does not represent a collection on accounts receivable or a bank transfer, determine its origin and carry out appropriate audit procedures.

6. Check December cash receipts from cash book to bank statement.

There are two approaches to auditing—a negative approach and a positive approach. The negative approach seeks to eliminate possibilities of fraud or error. Since these possibilities are infinite, the procedures are directed at only the most important possibilities of misstatement.

The positive approach to auditing is generally more useful. It involves determining that the system is adequate, that there is a logical reason for the deposit in transit, that the source is determined and verified, that the subsequent deposit in the bank occurs at a reasonable time. In short, it involves determining that the transaction rings true at every point it can be tested.

Procedures in groups (1) and (2) help the auditor to decide whether or not the records are reliable. More specifically, they help to establish that there had been a receipt and that it actually had been in transit on December 31, 1950. The procedures help to eliminate the possibility of a fictitious entry in the cash book or reconciliation. They help to eliminate the possibility of the cash book being held open.

Procedures in groups (3), (4), and (5) are directed at the reason for the receipt. Simply determining that the cash was received and deposited is insufficient verification. It is important to know why the cash was received and whether or not it should have been received. Confirmation of accounts receivable would help to uncover "lapping," and tracing inter-bank transfers would help to uncover "kiting."

No. 3 (7 points)

There is no check list to which an auditor can turn to find generally accepted accounting principles. There are, however, several approaches which the auditor can use to determine whether or not any given procedure is generally accepted at a given time. These approaches include:

1. A study of general practice as reflected in published financial statements. Surveys of published statements are available. If a given procedure is widely used in several different industries it has general acceptance.

2. A study of practice of other companies in the same industry. There is a distinction between "generally accepted" and "generally applicable." It is generally accepted, for example, that in certain special cases inventories may properly be valued above cost. Such a valuation procedure could not be called "generally accepted" if applied to other than these special cases.

3. A study of accounting literature. If a procedure has substantial authoritative support in accounting literature, it may be considered to be "generally accepted" even though it is not commonly used in practice.

4. Consideration of the results produced by the procedure. Determine whether it produces reasonable results from the standpoint of the balance-sheet and of the income statement. In some situations there may not be any other test of a procedure. While this test may not result in establishing the acceptability of a procedure, it does support its use.

No. 4 (12 points)

COMPUTATION OF INCOME TO BE DIVIDED

Profit per accounts		$ 9,000
Add:		
Partner's salary	$4,000	
Interest on capital	2,000	$6,000
Total income shared per term of agreement		$15,000

COMPUTATION OF ORDINARY NET INCOME

Total income (above)		$15,000
Deduct:		
Wholly exempt interest on City of Nash bonds	$ 60	
Partially exempt interest on U.S. Treasury bonds	20	
Gain on capital asset transactions	4,550	4,630
		$10,370
Add:		
Loss on capital asset transactions	$ 180	
Contributions	80	$ 260
Ordinary net income		$10,630

DIVISION OF ORDINARY NET INCOME

	Allen	*Bask*	*Total*
Interest on capital	$1,000	$1,000	$2,000
Salary	5,500	—	$5,500
Balance 1/3 & 2/3	1,043	2,087	3,130
Total	$7,543	$3,087	$10,630

DIVISION OF ITEMS NOT INCLUDED IN ORDINARY NET INCOME

	Allen (1/3)	*Bask* (2/3)	*Total*
Partially exempt interest	7	13	20
Long-Term capital gain on building (Note A)	1,516	3,034	4,550
Short-term capital gain on American Products Corp. stock (100%) (Note B)	250	500	750
Charitable contributions	27	53	80

Notes: a. Although not a capital asset, the gain is preferably reported here as it is subject to the benefits of Sec. 117 (j). Only 50 per cent of the amount is taxable to the partners.

b. American Products Corporation stock taken on partnership books at $2,080, but sold for $1,900. Bask's basis of $1,150 becomes partnership's basis for tax purposes. Therefore partnership's gain is $1,900 — $1,150=$750. However, it may be possible that under the partnership agreement, it would be decided that the $930 increase in value from date of purchase to date of acquisition by the partnership should all be taxable to Bask. In that case, a short-term loss of $180 would be divided among the partners.

No. 5 (12 points)

a. The auditor seeks to obtain the best available supporting evidence with a minimum of effort and expense. In most cases, the best evidence that accounts receivable are correctly recorded is direct acknowledgement by the debtor. This is not normally true of accounts payable. The best evidence that trade accounts payable are recorded is often the test of inventory as related to purchases and payables. The nature of the supporting evidence in the possession of the company is also a factor. Receivable records are usually originated entirely by the company. Records of payables are based, at least in part, on evidence prepared and sent in by outside parties such as invoices, statements, etc.

Accounts receivable are less likely to be understated than accounts payable. If no record of receivables were maintained, collections would dwindle. If no record of payables were maintained, persistent reminders would be forthcoming from the creditors. The audit of accounts receivable, therefore, emphasizes obtaining evidence to support recorded accounts. The audit of accounts payable emphasizes finding that all payables are recorded. Confirmations are more useful for the former purpose than for the latter.

Confirmation of accounts receivable is generally accepted auditing procedure. If the auditor does not confirm accounts receivable he must disclose his omission in his audit report (certificate). Only one other procedure, the physical testing of inventories, has been accorded this recognition of importance. In effect, the burden of proof is on the auditor to justify an omission of the confirmation procedure and the auditor is, therefore, reluctant to omit it.

b.

(Date)

(Creditor's name and address)

Gentlemen:

In connection with the regular annual audit of our accounts will you kindly inform our auditors (name and address) of our liability to you at (date).

Please list each note separately and specify amount, due date, interest rate,

interest dates, and collateral if any.

Your courtesy in this matter will be much appreciated. A stamped, addressed envelope is enclosed for your convenience.

Very truly yours,
(Client's name)

No. 6 (7 points)

The checking of postings is one step in tracing transactions from the original evidences through entries in journals to their summary in ledger accounts. Tracing in this manner helps to verify the individual entries in an account, and the theory is that if the individual entries are correct the balance should be correct.

As accounting records and procedures have improved and systems of internal control have developed, the auditor has been able to rely to an increasing extent on the accuracy of the mechanical features of accounting systems. These improvements in business records, together with a change in the nature of the auditor's function and responsibility, have caused the auditor to decrease the relative amount of his effort which was devoted to proof of mechanical accuracy and to change his technique of establishing the substantial accuracy of his client's records.

Checking of postings is only one of many means of accomplishing the same ends. It is limited because it deals with recorded data and usually will not lead to discovery of unrecorded transactions. Furthermore, it is largely a mechanical test and has the same limitations as all thoughtless and mechanical procedures.

While the accuracy of records is still of major concern to the auditor, he considers that he has more effective means for determining accuracy than by tracing postings from books of original entry to the ledger. Frequently the auditor works from the ledger accounts back to the original evidence; for example, the analysis of fixed-asset accounts involves inspection of invoices. Frequently the auditor can help to establish the accuracy of postings by "cross check" of totals such as the tie-up of depreciation expense with the credit to the asset reserve or the proof of insurance expense with the write-off of prepaid insurance. Sometimes the auditor does make tests of postings for limited periods and then relies on the assurance obtained from that test, his knowledge of internal control and his other procedures to establish the accuracy of all postings.

In general, any procedure which helps to verify account balances will also contribute to the auditor's assurance that postings are correct. Such procedures include:

1. Study of internal control.
2. Taking of trial balances.
3. Reconciling between control accounts and subsidiary ledgers.
4. Confirmation such as receivables.
5. Physical inventories or counts.
6. Comparison of account balances with prior year balances; study of ratios and percentages.

7. Analysis of accounts.

8. Testing of interrelationship of accounts, such as interest expense with notes payable.

No. 7 (16 points)

a. You might discover the existence of the contract by any of the following procedures:

1. Making a tour of the plant and asking questions about operations.

2. Inquiring of management about unusual commitments or contracts or future plans. A standard liability certificate might elicit the information. It is to be noted there is no apparent intention to conceal information from the auditor, but instead management's attitude seems to be that the information is not related to the audit.

3. Since contracts, leases, etc., are frequently filed together the contract could be observed when reviewing other contracts. It is not unusual for an auditor to look through the contract file as a routine procedure.

4. The minutes would contain authorization for the bank account, if in the name of the corporation.

5. The minutes might contain authorization for the contract or authorization for future construction which would be necessary for full scale operations.

6. Ratio and percentage analysis might disclose variations which would call for special investigation.

7. Routine procedure for the audit of inventory such as a review of payroll distribution might disclose the special development work, especially if perpetual inventory records are maintained.

8. In connection with the audit of sales, the examination of sales invoices and testing of invoices against sales orders and shipping records might disclose the unusual transaction.

Any information disclosed by the above would call for investigation or explanation and should result in discovery of the existence of the contract.

b. A program for audit of transactions under the contract might be as follows:

1. Read the contract and make abstracts.

2. Determine that the contract has been properly authorized.

3. Audit the special cash account including direct confirmation from the depository.

4. Review monthly statements, including test vouching of all amounts appearing thereon. Make sure the costs under the contract are excluded from inventory.

5. Confirm from Clar Chemical in regard to its acceptance of the monthly statements which have been rendered, and the amount of the advance.

6. Determine proper balance-sheet classification and prepare entries to set up transactions under the contract on the corporation's books.

c. The balance-sheet should show as a current or special asset:
Balance of advance under special contract (contra) $23,250
Current or special liabilities should include:
Deposit liability under special contract (contra) $23,250

December cost of $20,500 should be excluded from inventory and general cash should be increased by the same amount. There appears to be no need for a footnote unless Clar Chemical has not accepted statements rendered for October, November and December and the auditor feels interpretation of the contract or compliance with its terms is doubtful. In this event, disclosure of the contingent liability would be necessary. Unusual commitments for plant would be disclosed whether or not in connection with the contract.

If a detailed report is issued, informative comments on the contract would appropriately be included.

No. 8 (18 points)

a. Supplying the receiving department with the purchase order is regarded as a weakness in that the department may be less careful in checking goods than they would be if they were working without a record of the quantities that should be received. The use of a "blind" copy of the purchase order i.e., one not showing quantities, would remedy that condition. The failure to have the storekeeper receipt for the materials when they are sent to him from the receiving department or to tie in the items placed in stores with the purchase constitutes a weakness in control in that responsibility for shortages cannot be definitely placed on either receiving or stores. The receiving department might, in collusion with a vendor, report receipts of materials which never were received. Also either the receiving department or the stores department might fraudulently convert some of the materials and because of the lack of a record of responsibility, the company would be unable to determine which one was responsible. The information given implies that a perpetual inventory is not kept. Requiring that the storekeeper approve the purchase order as to quantity received, or that he give a receipt to the receiving department for goods which he receives would permit the determination of responsibility for shortages as between the two departments. Maintenance of a perpetual inventory record is essential if the storekeeper is to be held accountable for material inventory.

b. The payroll checks should not be returned to the supervisor but should be distributed by persons independent of those having a part in making up the payroll data. The existing situation affords the supervisor an opportunity to pad the payroll with fictitious names and to extract the checks made out in such names when they are returned after having been signed.

c. One apparent weakness is that of divided responsibility for the unissued bonds. Either the cashier or his substitute might collect a prepayment from an employee, issue the bond and pocket the cash. In the subsequent periodic check by the independent employees, a shortage would develop, but responsibility therefor could not be clearly fixed. When the regular cashier is absent, he should turn a small supply of bonds over to the substitute and take a receipt. Upon his

return, the substitute cashier should account to him either with bonds or with employee's receipt. In addition to this weakness, there is an opportunity for the cashier to abstract cash paid in by an employee, issue the bond and show the account for the employee as having been paid up through payroll deductions. This shortage could be covered by not posting a payroll credit to some other employee. Tests of the postings of payroll deduction credits to the employees' accounts would finally disclose that kind of manipulation.

d. The bank statement and cancelled checks should not be reconciled by the manager but should be sent by the bank direct to the home office where the reconciliations should be made against the manager's report of disbursements. Vouchers should be sent in to support disbursements. In the existing situation, the manager may draw checks to himself or others for personal purposes and omit them from his list of disbursements. The shortage thus created in the imprest fund account may run without detection for some period or he may cover it by inflating on his report the amounts of other checks.

No. 9 (8 points)

The primary purpose of an audit is to add credibility to management's statements of financial position and results of operations. It is now generally recognized that the income statement is at least as significant as the balance-sheet. If only the balance-sheet were certified the report would not be considered satisfactory by many users of financial statements.

It is true that if the balance-sheet has been verified, the net income has been verified since it represents the difference between proprietorship at the beginning and end of the period, after adjustment for any other individual item is fairly presented. Analysis of statements involves use of these items in computing ratios.

Of more direct importance is the fact that verification of balance-sheet items involves verification of the related income and expense items. The verification of accounts receivable cannot be divorced from the verification of sales; verification of notes payable involves analysis of interest expense; verification of fixed assets requires a review of expense accounts for expenditures which should have been capitalized.

An examination of expense accounts may lead to the discovery of fraud. For example, when uncollectible customers' accounts are charged to expense rather than to a reserve, a verification of the expense account may disclose improper write-offs which were made to cover misappropriations.

It is possible that credits to income accounts should have been made to expense accounts, and vice versa.

A scrutiny of the expense accounts, in comparison with those of comparable prior periods may lead to the disclosure of irregularities through observation of variations in the pattern of costs and expenses in relation to income.

Commercial Law

May 18, 1951; 9 a.m. to 12:30 p.m.

Group I

No. 1 (10 points)

a. The important rights of a shareholder in a corporation are:

(1) The right to participate in the control of the corporation by attending stockholders' meetings, voting his stock for the election of directors and on other important matters vitally affecting the corporation, such as the bylaws, merger consolidation of the corporation with another, etc. A statute or provision in the charter may restrict the voting rights (Fletcher, #2097, #2104).

(2) The right to dividends when lawfully declared by the directors (Fletcher, #5321, #5322, #5451).

(3) The right to inspect the books and records of the corporation at any reasonable time and place, and for a purpose reasonably related to his interest as a stockholder (Fletcher, #2213 et seq.).

(4) The right to transfer or assign his stock, unless restricted by the subscription contract, the charter or valid bylaws of the corporation (Fletcher, #4205, #4206, #5452 et seq.).

(5) Pre-emptive rights. That is, the stockholders at the time of increase in stock to be issued by the corporation have a preference over other persons to subscribe for or purchase the new stock in proportion to the number of shares held by them (Fletcher, #5135 et seq.).

(6) The right to maintain a derivative action. A derivative action is a suit brought by a shareholder or group of shareholders to enforce a corporate cause of action. The relief granted is a judgment against a third person in favor of the corporation. An instance is where the officers or directors have made secret profits for themselves and the stockholders seek to recover those profits for the benefit of the corporation.

This is to be distinguished from a class or representative suit where a stockholder in his own behalf and in behalf of all others similarly situated sues the corporation for a right belonging individually to the members of the group against the corporation. An instance is where a preferred stockholder on behalf of himself and all other preferred stockholders sues the corporation for dividends lawfully declared but unpaid (Fletcher, #5322, #5908 et seq.; see *Price* v. *Gurney,* 324 U.S. 100, 105 (1945)).

(7) On dissolution the stockholders have the right to participate in proportion to their stock holdings in the distribution of assets after all of its debts are paid (Fletcher #8224 et seq.).

b. The status of a shareholder after a dividend has been declared, but before it has been paid, is dependent upon the following circumstances:

(1) If a fund has not been set aside from which the dividends are to be paid, then the stockholders are ordinary unsecured creditors of the corporation to the extent of the dividend and are on a parity with other corporate creditors that are unsecured and without preference (Fletcher, #5322).

(2) If a fund has been set aside from which the dividends are to be paid, that fund operates as a trust for the benefit of the stockholders and therefore the stockholders may be said to be secured creditors to the exclusion of other creditors (Fletcher, #5322).

c. Voting by proxy means that the voting power of the stockholder is delegated to an agent who acts in the place of the stockholder. As a general rule a stockholder may confer on his proxy any power which he may himself possess as a stockholder to act as such at a corporate meeting. This is generally done by giving the proxy a power of attorney (Fletcher, #2050; 14 C.J. #1404-9).

d. A dividend may be revoked:

(1) When its declaration is illegal or ultra vires.

(2) When, though lawful and regular, it is revoked at the same meeting at which it was declared.

(3) When it is payable at a future time and the declaration has not been made public nor communicated to the stockholders.

(4) When it is a stock dividend and such stock has not yet been issued. Unlike the declaration of a cash dividend, the mere declaration of a stock dividend does not give rise to any indebtedness on the part of the corporation (18 C.J.S. Page 1115; Fletcher, #5323).

No. 2 (10 points)

a. Yes. Unless something remains to be done by the seller to put goods in deliverable condition, title to identified goods is presumed to pass at the time the contract is made. In this case B was free to take the goods at any time, so title and risk of loss passed to him at the date of sale. Unless the fire originated because of the carelessness of S, B must pay for the lumber. This assumes that the contract contained no stipulation as to when title was to pass (Uniform Sales Act, #19, Rule 1).

b. An unpaid seller has a lien on goods in his possession, even though the goods have been sold on credit and the credit period has not expired, if the buyer becomes insolvent; that is, has ceased to pay his debts in the ordinary course of business or is unable to meet his obligation as they mature. S does not have a right to deny delivery to T unless B had become insolvent (Uniform Sales Act, #54, #76).

c. No. S need not account to B. An unpaid seller in possession, having a right of lien, may, where the buyer has been in default in the payment of the price for an unreasonable length of time, resell the goods. The giving of notice of resale is relevant to the issue of whether or not there was a default for an unreasonable time. Since the goods were to be removed by the buyer within three months, with payment within 30 days thereafter, the default in payment was a full month. Even though notice was not given, this default may be construed as for an unreasonable length of time (Uniform Sales Act, #60).

No. 3 (10 points)

a. No. Absence or failure of consideration is a defense which is ineffective against a holder in due course (Uniform Negotiable Instruments Act, #28, 57).

b. Yes. At the time the note was purchased, the bank was not a holder in due course. The bank purchased in good faith, and before the note was overdue, but gave no value. The crediting of a depositor's checking account does not constitute the payment of value. However, when the bank honored checks drawn on the account, it became a holder for value or a holder in due course to the extent of the amount paid (Uniform Negotiable Instruments Act, #52; 10 C.J.S., pp. 803-806).

c. Five hundred dollars. A bank becomes a holder for value by honoring checks drawn against the credit it has given as the purchase price of an instrument. If the bank learns that the maker of an instrument has a defense on the instrument before the bank pays full amount of credit it has given, the bank is a holder for value only to the extent that it has actually paid. Most courts apply the "first money in is the first money out" rule in determining the extent of the value given for the instrument. The $175 on deposit at the time the credit for $550 was entered in A's account would be deemed to have been paid first. Thus $500 was paid from the credit given for the note before the bank learned of the defense (Uniform Negotiable Instruments Act, #54; 36 C.J.S., p. 823).

No. 4 (10 points)

a. The contract may not be rescinded. A unilateral mistake does not justify rescission unless the error is so large the offeree must have realized it existed at the time he accepted the offer. There is nothing in the facts to suggest that O knew of the error at the time he accepted the offer or that he had any reason to believe that an error had been made (Restatement-Contracts, #503).

b. No. Consideration was not present to support the promise. Doing what one is legally obligated to do cannot operate as consideration for an act or promise of another. A promise unsupported by consideration is unenforceable (Restatement-Contracts, #19, 75).

c. Yes. For every breach of a contract, damages are recoverable unless the breach is excused because of impossibility of performance. In this case the ability to perform was of the essence of the contract, and nothing suggests that the delay was the result of impossibility due to the nature of the performance rather than mere unanticipated difficulty (Restatement-Contracts, ##314, 327, 454, 455).

No. 5 (10 points)

a. A properly appointed agent who has authority to sell personal property has implied authority to make the usual warranties of title, which are:

(1) that the principal has good title to the subject matter of the sale;

(2) that the owner has authority to make the sale;

(3) that the article is free from encumbrances other than those disclosed; and

(4) that the purchaser will have quiet enjoyment of the property (Restatement-Agency, #35, 63 Uniform Sales Act, #13).

b. (1) When an agent is authorized to enter contracts required by the Statute of Frauds to be in writing, many states, by statute, require the authority of the agent to be in writing. This is analogous to the common law rule that the authority

of an agent to execute a sealed instrument must be conferred by an instrument of equal dignity; that is, by an authorization under seal (orbin, Contracts #526; 2 C.J.S., pp. 1055, 1060).

(2) An agent's authority must be set forth in a written instrument where the agency relates to:

(a) The sale of real estate (Williston, Contracts, #276).

(b) Other contracts required by the Statute of Frauds to be in writing, where by statute the authority of an agent to execute such a contract must also be in writing; for example, contracts not to be performed within one year, contracts in consideration of marriage; and contracts for the sale of goods above a certain price and without part performance, etc. (Restatement-Contracts, #178).

(c) The execution of any contract under seal where a seal has not been deprived by statute of its efficacy (Restatement-Agency, #28).

c. An agent's authority is terminated in several situations by operation of law, regardless of the consent or intention of the parties. Among those events which the law deems sufficient to end the agent's authority are:

(1) Death of principal or agent;

(2) Bankruptcy of principal or agent;

(3) Insanity of principal or agent;

(4) War between the country of the principal and the country of the agent;

(5) Change of laws making the subject matter of the agency illegal;

(6) Adverse interest or employment by the agent without the consent of the principal, and

(7) Loss, destruction or sale of the subject matter of the agency (2 C.J.S. ##82-86) (Restatement-Agency #110 et seq.)

Group II

No. 6 (10 points)

a. Yes, the trustee may do so, if B was insolvent on January 10th, and if at that time C had reasonable cause to believe that B was insolvent. A preference which is obtained within the four months immediately prior to bankruptcy may be avoided by the trustee provided the creditor knew or had cause to believe that the debtor was insolvent. In such a case, C becomes an ordinary unsecured creditor (Bankruptcy Law, 11 United States Code, #96).

b. No. The Bankruptcy Code lists six acts of bankruptcy but the fact of insolvency alone is not such an act (Bankruptcy Law, 11 United States Code, #21 (a).

c. The purpose of voluntary bankruptcy is most often to release the debtor of his liabilities, although occasionally the debtor may have in mind a desire to see a fair distribution of assets among his creditors. Involuntary bankruptcy has for its purpose the compelling of a fair distribution of assets among all of one's creditors, rather than leaving it to the insolvent debtor to distribute to them as he sees fit.

d. Yes. C may collect the remaining $400 which is not discharged by B's bankruptcy. Claims based upon false pretenses or misrepresentations are not

discharged. They carry over and become claims against the bankrupt's now estate. Since the liability of the bankrupt was for obtaining money by a false representation or false pretense, it was not discharged and C should be able to collect the remaining $400 (Bankruptcy Law, 11 U. S. Code, Sec. 35(a) (2).

No. 7 (10 points)

a. (1) A straight bill of lading states that goods are consigned to a specified person. Such a bill is not negotiable and carries no better rights to a purchaser than the consignee had (Uniform Bills of Lading Act, ##4, 30, and 33).

(2) An order bill of lading is one that states that goods are consigned to order of any person named therein. Such a bill is negotiable and when properly indorsed may convey better rights than the consignee had (Uniform Bills of Lading Act, #5 and 32).

b. No. While an order bill of lading, properly endorsed, in the hands of an innocent purchaser, may be enforced in cases of fraud, etc., a forged endorsement on an order bill carries no title to the bill or the goods to the purchaser. C did not obtain title to the furniture (Uniform Negotiable Instruments Act, #23; Uniform Bills of Lading Act, ##29, 31, 38).

c. Yes. If a duly authorized employee of a carrier wrongfully issues an order bill of lading for goods never received, and the bill is properly negotiated to an innocent purchaser for value, such a purchaser may hold the carrier for the agent's wrongful act (Uniform Bills of Lading Act, 23).

No. 8 (10 points)

a. Yes. A surety becomes liable upon default in payment of the debt by the principal debtor. The creditor may hold the surety, or sureties, without pursuing any other remedy he may have (50 Corpus Juris, Page 191, 323) (Restatement-Security ##130 and 131).

b. Yes. When a debtor does not stipulate which debt he is paying to a creditor, when the debtor owes that creditor more than one debt, the creditor may apply the payment to any debt he chooses. The surety has no right to insist on application of the payment to the debt for which he is liable (50 Corpus Juris, Page 104, Sec. 177) (Restatement-Contracts #387—Security #142).

c. Yes. A valid contract, between the debtor or sureties, to extend the time of payment of the debt without the consent of the surety or sureties releases the surety or sureties. (If the surety is a compensated surety, he is released only to the extent that he is harmed by the extension. Also it is possible for the creditor to reserve his rights against the surety by provision in the extension contract.) (Restatement—Security #129).

d. Yes. When sureties assume liability by different contracts for the same debt, the creditor can hold any surety for the full amount of the debt (50 Corpus Juris, Page 191, Sec. 323).

e. Yes. If there are two or more sureties for the same debt, there arises an implied contract between the sureties that each is to pay his proportionate share of the debt in case of default. A surety who pays more than his share can recover from the other surety or sureties in proportion. In this case, S could recover $2,500 from T (Restatement-Security ##144, 146, 149, and 154).

No. 9 (10 points)

a. No. The Statute of Frauds provides that a contract for the transfer of any interest in or concerning real property must be evidenced by a writing signed by the person sought to be held to the contract. Leases up to one year, and in some states, up to three years have been excepted. In most states, taking possession or making a partial payment does not make the agreement enforceable. However, if the buyer has gone so far as to make it impossible to restore him to his former condition, the oral agreement will be enforced. Possession, the cost of remodeling, and the surrender of other connections have often afforded the basis for enforcement of an oral contract (Corbin, Contracts, ##402, 427, 431, 433).

b. No. Normally a promise to accept a lesser sum in full payment of a stipulated larger sum is unenforceable because of lack of consideration. Doing what one is obligated to do is not consideration for another's promise. The promise to accept the lesser sum in full is unenforceable, but the giving of the receipt marked "in full" is evidence of a gift of the balance. On this latter basis, L may not be able to collect the shortage (Corbin, Contracts, ##175, 1246-7).

c. Yes. A misrepresentation of a material fact by one of the parties to a contract makes it possible for the injured party to avoid the agreement. The size of a room to be used for restaurant purposes is certainly material, and even though the statement was made innocently, the injured party has the right to avoid (Restatement-Contracts, ##470, 476).

d. No. Fraud consists of an intentional misrepresentation of a material fact which induces another to enter into a contract. Mere silence or failure to disclose valuable information does not constitute fraud unless there is a fiduciary relationship between the parties. There appears no evidence in this case that a close relationship of trust and confidence existed between the parties. Consequently, no fraud resulted from the silence and T may not have the contract avoided (Restatement-Contracts, ##471, 472).

No. 10 (10 points)

a. (1) Expressly by the offeror before acceptance.

(2) By lapse of time specified in the offer.

(3) By lapse of reasonable time if no time is specified.

(4) By death or insanity of either the offeror or offeree.

(5) By destruction of the subject matter.

(6) By supervening legal prohibition of the proposed contract.

(Restatement-Contracts, ##35, 48).

b. (1) In all states an offer supported by sufficient consideration (namely, an option) may not be revoked either for the time stated in the offer or, if no time is fixed, within a reasonable time.

(2) In some states (reflecting the common law rule) an option under seal is binding because a seal under the common law imports consideration (Corbin, contracts, #263).

c. No. Such an agreement is not valid as the restraint is unreasonable, and it is not necessary to protect the purchaser (Restatement-Contracts, ##513—15; Corbin, Contracts, #1393).

d. This agreement would be enforceable where necessary to protect the employer against disclosure of trade secrets obtained in confidence during the course of his employment. This agreement would probably not be enforceable where the employee had no access to trade secrets, because it would then be an unreasonable restraint of employment and against public policy (Corbin, Contracts, #1394).

No. 11 (10 points)

1. True. Uniform Partnership Act, #29
2. False. Uniform Partnership Act, #27
3. True. Uniform Partnership Act, #31 (5)
4. True. Uniform Partnership Act, #31 (2)
5. False. Uniform Partnership Act, #35 (1) (b) III
6. True. Uniform Partnership Act, #41 (1) and #29
7. False. Uniform Partnership Act, #41 (1)
8. False. Uniform Partnership Act, #41 (7)
9. True. Uniform Partnership Act, #36 (1)
10. True. Uniform Partnership Act, #25 (2) (d) and (e)

No. 12 (10 points)

1. False. (Uniform Negotiable Instruments Act, #7 (2))
2. True. (Uniform Negotiable Instruments Act, #2 (1); Brannan, Negotiable Instruments Law, #2 (1), p.109.)
3. False. (Uniform Negotiable Instruments Act, #4 (3))
4. True. (Uniform Negotiable Instruments Act, #4 (3))
5. True. (Uniform Negotiable Instruments Act, #5 (4))
6. False. (Uniform Negotiable Instruments Act, #6(2))
7. False. (Uniform Negotiable Instruments Act, #9 (4))
8. True. (Uniform Negotiable Instruments Act, #9 (5))
9. True. (Uniform Negotiable Instruments Act, #6 (3))
10. False. (Uniform Negotiable Instruments Act, #12)

Accounting Practice—Part I

November 7, 1951; 1:30 to 6 p.m.

Examination Answers, November, 1951

No. 1 (15 points)

Part a.

1. (b) False.
2. (a) True under 1950 Act. (b) False under 1951 Act.
3. (b) False.
4. (a) True.
5. (b) False.
6. (a) True.
7. (a) True.
8. (a) True.
9. (b) False.
10. (b) False.
11. (a) True.
12. (b) False.
13. (b) False.
14. (b) False.
15. (b) False.
16. (1) (b) False.
    (2) (b) False.
    (3) (b) False.
17. (1) (a) True.
    (2) (b) False.

Part b.

1. (d) $1,400.
2. (a) 0.
3. (b) $4,000.
5. (c) $1,889 under 1950 Act; (d) $2,189 under 1951 Act if either spouse is over 65.
6. (1) (e) $1,200.
   (2) (b) $1,750.
   (3) (b) $1,250.

Part c.

1. (c).
2. (b).
3. (b).
4. (a).
5. (a).
6. (c).
7. (b).
8. (b).
9. (c).
10. (b).
11. (b).
12. (c).
13. (c).
14. (c).
15. (a).
16. (a).
17. (a).
18. (b).
19. (b).
20. (a).

No. 2 (20 points)

THE HARDWARE AND FURNITURE COMPANY

Balance-Sheet—December 31, 1950

ASSETS		
Current Assets:		
Cash		$ 3,966
Accounts receivable	$11,921	
Less—Allowance for losses	700	11,221
Merchandise inventory		17,807
Prepaid insurance		122
Supplies		105
		$33,221
Fixed Assets:		
Fixtures	$ 3,130	
Less—Accumulated depreciation	1,423	$ 1,707
Total assets		$34,928

LIABILITIES AND CAPITAL			
Current Liabilities:			
Note payable			$ 2,000
Accounts payable—trade			5,154
Accrued taxes			216
Other accrued expenses			73
Total liabilities			$ 7,443
Roberts, Capital:			
Balance January 1, 1950		$26,839	
Profit for 1950	$6,786		
Withdrawals	6,140	646	
Balance December 31, 1950			$27,485
Total liabilities and capital			$34,928

Statement of Income and Expense Year Ended December 31, 1950

Sales			$85,060
Cost of goods sold:			
Inventory January 1, 1950	$19,243		
Purchases	58,451		
	$77,694		
Inventory December 31, 1950	17,807		59,887
Gross profit			$25,173
Selling and general expenses:			
Salaries		$10,988	
Rent		3,600	
Heat, light and telephone		394	
Insurance		377	
Supplies		254	
Depreciation of fixtures		313	
Provision for loss on accounts		772	
Taxes		1,031	
Miscellaneous expenses		658	18,387
Net profit for the year			$ 6,786

THE HARDWARE AND FURNITURE COMPANY

Worksheet for December 31, 1950 Statements

	December 31, 1949 Balances		*1950 Transactions*		*Profit & Loss Accounts*		*Balance-Sheet Accounts*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash	$ 5,175		(1) $ 43,083	(2) $ 304			$ 3,966	
			(2) 40,104	(3) 55,461				
				(9) 28,609				
				(4) 22				
Accounts receivable	10,556		(7) 45,260	(5) 812			11,921	
				(1) 43,083				
Allowance for loss on accounts		$ 740	(5) 812	(6) 772				$ 700
Fixtures	3,130						3,130	
Accumulated depreciation		1,110		(8) 313				1,423
Prepaid insurance	158		(9) 341	(12) 377			122	
Supplies	79		(9) 280	(13) 254			105	
Accounts payable		4,244	(3) 55,461	(10) 57,789				5,154
			(10) 1,418					
Accrued miscellaneous expense		206	(9) 769	(15) 636				73
Accrued taxes		202	(9) 1,017	(14) 1,031				216
Merchandise inventory	19,243		(11) 17,807	(11) 17,807	$ 19,243	$ 17,807	17,807	
Note payable		5,000	(9) 3,000					2,000
Roberts—Capital		26,839						26,839
Roberts—Drawings			(9) 6,140				6,140	
Sales				(7) 45,260		85,060		
				(2) 39,800				
Purchases			(9) 2,080		58,451			
			(10) 56,371					
Salaries			(9) 10,988		10,988			
Rent			(9) 3,600		3,600			
Heat, light and telephone			(9) 394		394			
Miscellaneous expense			(4) 22		658			
			(15) 636					
Insurance			(12) 377		377			
Supplies			(13) 254		254			
Tax expense			(14) 1,031		1,031			
Depreciation of fixtures			(8) 313		313			
Provision for loss accounts			(6) 772		772			
Net profit					6,786			6,786
	$38,341	$38,341	$292,330	$292,330	$102,867	$102,867	$43,191	$43,191

No. 3 (15 points)

APPLICATION OF FUNDS STATEMENT YEAR ENDING DECEMBER 31, 1950

Sources of Funds:			
Net profit per books		$48,097	
Add charges included which did not require funds:			
Write off of bond discount	$ 1,438		
Depreciation	14,120		
Loss on retirement of assets	2,520	18,078	$ 66,175
Sale of assets retired			1,000
Decrease in working capital (see schedule)			43,675
Total funds provided			$110,850
Application of Funds:			
Retirement of bonds	$13,755		
Less premium charged to expense*	255		$ 13,500
Repurchase of stock			8,325
Increase in cash value of life insurance			746
Purchase of machinery			31,365
Construction of building			36,264
Payment of dividend			9,250
Payment of prior year's taxes			11,400
Total funds applied			$110,850

*The total of $13,755 might be considered as funds applied and the $255 shown as an adjustment to net profit.

Schedule of Changes in Working Capital

Current Assets:	*Balance Dec. 31, 1949*	*Balance Dec. 31, 1950*	*Increase*	*Decrease*
Cash	$ 40,409	$ 30,337		$10,072
Accounts receivable less reserve	62,556	61,823		733
Temporary investments	112,500	85,000		27,500
Inventories less reserve	81,164	86,938	$ 5,774	
Prepaid insurance	710	755	45	
Total	$297,339	$264,853	$ 5,819	$38,305
Current Liabilities:				
Accounts payable	$ 34,081	$ 31,314		$ 2,767
Notes payable	40,000	45,000	$ 5,000	
Accrued expenses	12,307	21,263	8,956	
Bonds payable—current portion	5,000	5,000		
Total	$ 91,388	$102,577	$13,956	$ 2,767
Working capital	$205,951	$162,276		$43,675

Accounting Practice—Part II

November 8, 1951; 1:30 to 6 p.m.

No. 1 (12½ points)

COMPUTATION OF RENT PAYABLE BY YEARS

Year	*Payable on Sales*	*Minimum*	*Carry-Forward*	*Loss of Carry-Forward*	*Amount Payable*
1942	$2,880	$4,000	$1,120	..	$4,000
1943	3,870	4,000	130	$1,120	4,000
1944	4,440	4,000	..	..	4,310
1945	4,720	4,000	..	..	4,720
1946	3,720	4,000	280	..	4,000
1947	4,230	4,500	270	280	4,500
1948	4,800	4,500	..	..	4,530
1949	4,260	4,500	240	..	4,500
1950	4,900	4,500	..	..	4,660
1951	5,440	4,500	..	..	5,440

b. The right to apply a payment to the next year's rent to the extent such a payment was caused by the requirement of the rent equalling a minimum amount raises the possibility of deferring such a payment in the year in which it is made. If there is such a deferral, the amount deferred would be treated as an expense of the second year. Unless some amount is deferred, the entire payment made in any year would be considered expense without regard to whether the payment was based on sales or on the fixed minimum. The argument for deferring is applicable in a year such as 1943 when $130 is paid because of the minimum but is used as a reduction of 1944 rent when only $4,310 is paid instead of the $4,440 which would be payable on the basis of sales.

The experience of the business does not indicate any assurance that an amount which would be deferred in one year will be of value to the next year's operation. Unless there is a reasonable basis for concluding that a payment will benefit subsequent years, it is not usually acceptable to defer such a payment. Because of the uncertainty in this situation it appears to be desirable to charge the full amount of each year's payment to current expenses of that year.

No. 2 (12½ points)

COMPUTATION OF BOOK VALUE OF COMMON STOCK

Preferred stock	$185,000
Common stock	400,000
Reserve for bond retirement	160,000
Premium on preferred stock	10,000
Premium on common stock	67,300
Retained earnings	131,260
Total of capital and surplus accounts	$953,560
Less amount assignable to preferred stock*	203,500
Equity applicable to common stock	$750,060
Book value for each of 4,000 shares	$187,515

*Book value is not consistent with value under compulsory liquidation but rather is a computation on a going concern basis. Therefore, the preferred stock is assigned its voluntary liquidation value rather than its involuntary liquidation value.

COMPUTATION OF THEORETICAL VALUE OF RIGHTS

100 Shares @ $172.50	$17,250
50 Shares @ $150.00	7,500
Total value of Doe's stock and rights	$24,750
Average value of one share if rights are exercised	$ 165
Cost of a share using rights	150
Value of right to buy one share	$ 15
Value of right to buy 50 shares	$ 750

c. A stockholder is not considered to have received income upon receipt of a stock right. Neither does he receive income when the right is exercised if exercise of the right does not give him a different interest from what he previously had in the corporation. There is taxable income received by a stockholder upon exercise of a stock right if he receives a different interest. In this instance of a common stockholder receiving a right to subscribe to common, the exercise of the rights would not create taxable income. At the time non-taxable rights are exercised or sold, an apportionment of the tax basis of the stock is made between the rights and the stock. This apportionment is made on the basis of the relative market values of the stock and the rights at the date on which the rights accrued. In the foregoing case the apportionment would be as follows:

Market value of rights (assume market value is the same as the theoretical value)	$ 750
Market value of stock ex-rights	16,500
Total	$17,250

Basis of rights $\frac{750}{17,250}$ of $16,431.20 equals $714.40

Basis of stock $\frac{16,500}{17,250}$ of $16,431.20 equals $15,716.80

When rights are sold they are considered to have been held from the same date as the original stock. Therefore, in this instance the sale for $800 of the rights would result in a gain of $85.60, one-half of which would be taxable since it is a long-term capital gain.

No. 3 (25 points) (Optional with No. 4)

THE MEMORIAL HOSPITAL
Worksheet for General Fund Year 1951

	Balance, January 1		1951 Transactions		1951 Income & Expense		1951 Surplus Changes		December 31, 1951 Balance-Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$18,908		$138,710 (1) 30,805 (3) 925,428 (5) 1,375 (6)	$1,112,744 (13)					$ 2,482	
Accounts receivable—patients	48,740		930,480 (4)	912,538 (5) 6,302 (7) 14,105 (12)					46,275	
Sundry accounts receivable	508		1,073 (14)	1,375 (6)					206	
Allowance for loss on accounts		$10,385	6,302 (7)	10,000 (7)						$14,083
Inventory of supplies	17,583		78,240 (9)	73,651 (14)					22,172	
Prepaid insurance	3,294		11,624 (9)	10,445 (14)					4,473	
Accounts payable		29,227	610,043 (13) 2,305 (13)	608,263 (9)						25,142
Other current liabilities		38,014	502,701 (13)	505,212 (9)						40,525
Advance payments by patients		6,364	14,105 (12)	12,890 (5)						5,149
General fund balance (surplus)		5,043						$ 5,043		
Retirement of bonds			10,000 (9)		$ 10,000					
Income from endowment investments				138,710 (1)		$ 138,710				
Donations				30,805 (3)		30,805				
Gross earnings from services to patients				$ 930,480 (4) 108,000 (11)		1,038,480				
Provision for loss on accounts			10,000 (7)		10,000					
Depreciation on buildings			11,307 (8)		11,307					
Depreciation on equipment			18,541 (8)		18,541					
Replacement of equipment			11,432 (9)				$11,432			
Contribution to expenses from plant fund				29,848 (8)				29,848		
General operating expenses			979,731 (9) 72,578 (14)		1,052,309					
Maintenance			7,448 (9)		7,448					
Bond interest			15,000 (9)		15,000					
Free services			108,000 (11)		108,000					
Discounts on invoices				2,305 (13)		2,305				
Insurance expense			10,445 (14)		10,445					
Net loss						32,750	32,750			
	$89,033	$89,033			$1,243,050	$1,243,050				
General fund balance (surplus)								9,291	9,291	
							$44,182	$44,182	$84,899	$84,899

THE MEMORIAL HOSPITAL

Worksheet for Non-Current Funds Year 1951

	Balance, January 1		1951 Transactions		1951 Income and Expense		Fund Balance-Changes in 1951		Balance-Sheet December 31, 1951	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
			Special Expendable Funds							
Cash	$ 12,150		$ 11,765 (2)	$ 5,875 (15)					$ 28,540	
			10,500 (3)							
Expendable fund balance		$ 12,150						$ 12,150		
Donations				10,500 (3)				10,500		
Income from investments				11,765 (2)		$11,765				
Expenditures			5,875 (15)		$ 5,875					
Excess of income over expenditures					5,890			5,890		
Fund balance 12-31-51							28,540			$ 28,540
	$ 12,150	$ 12,150			$11,765	$11,765	$ 28,540	$ 28,540	$ 28,540	$ 28,540
			Endowment Funds							
Cash—General endowment	$ 112,808		$552,164 (16)	$507,892 (17)					$ 157,080	
Cash—Special endowment			52,125 (16)	48,100 (17)					4,025	
Stocks and bonds	3,702,010		507,892 (17)	502,164 (16)					3,700,384	
				7,354 (18)						
Other investments	225,950			52,125 (16)					163,847	
				9,978 (18)						
General endowment fund balances		$3,814,818						$3,814,818		
Special endowment fund balances		225,950						225,950		
General endowment donation				50,000 (16)				50,000		
General endowment fund loss			7,354 (18)				$ 7,354			
Bonds—Special fund			48,100 (17)						48,100	
Special endowment fund loss			9,978 (18)				9,978			
General endowment fund balances 12-31-51							3,857,464			$3,857,464
Special endowment fund balances 12-31-51							215,972			215,972
	$4,040,768	$4,040,768					$4,090,768	$4,090,768	$4,073,436	$4,073,436
			Plant Funds							
Land	$ 25,000								$ 25,000	
Buildings	402,305			$ 11,307 (8)					390,998	
Equipment	106,500		$ 11,432 (9)	18,541 (8)					96,681	
				2,710 (10)						
Bonds payable		$ 300,000	10,000 (9)							$ 290,000
Current fund bond retirement				10,000 (9)				$ 10,000		
Current fund purchase equipment				11,432 (9)				11,432		
Plant fund balance		$ 233,805						233,805		
Depreciation charge			29,848 (8)				$ 29,848			
Equipment retired*			2,710 (10)				2,710			
Fund balance 12-31-51							222,679			222,679
	$ 533,805	$ 533,805					$ 255,237	$ 255,237	$ 512,679	$ 512,679

*The undepreciated cost of equipment retired might also be shown among the expenses of the general fund with a corresponding credit to the general fund balance.

No. 4 (25 points) (Optional with No. 3)

THE TOWN COMPANY
Cost of Production for April

	Pounds	Amount	Per Pound
Department 101			
Materials used	18,000	$134,090	
Labor and overhead		87,442	
		$221,532	
Deduct income from Bypo: (1/5 of 18,000 lbs.—$.50 less $.05 selling expense)	3,600	1,620	
Balance transferred (see Schedule A)	14,400	$219,912	$15.27
Department 201			
Transferred from Department 101 (Schedule A)	4,800	$138,600	
Gain in weight in Department 201 (50%)	2,400		
	7,200	$138,600	
Labor and overhead (see Schedule B)	7,100	31,950	4.50
Total cost incurred in April		$170,550	$23.75
Add work-in-process inventory March 31		17,160	
Total cost to be distributed		$187,710	
Distribution of costs:			
In process April 30 at current cost:			
Transferred cost from Department 101	1,000	$ 19,250	$19.25
Cost in Department 201	500	2,250	$ 4.50
Total in process		$ 21,500	
Balance transferred to stock (first-in, first-out)	7,000*	166,210	$23.7443
Total as above		$187,710	
Department 301			
Transferred from Department 101 (Schedule A)	9,600	$ 81,312	$ 8.47
Labor and overhead (see Schedule B)	9,520	61,880	6.50
Total cost incurred in April		$143,192	$14.97
Add work-in-process inventory March 31		2,340	
Total cost to be distributed		$145,532	
Distribution of costs:			
In process April 30 at current cost:			
Transferred cost from Department 101	360	$ 3,049.20	$ 8.47
Cost in Department 301	180	1,170.00	$ 6.50
Total in process		$ 4,219.20	
Balance transferred to stock (first-in, first-out)	9,440*	141,312.80	$14.9696
Total as above		$145,532.00	

	201	301
*In process, March 31	800	200
Transferred in	7,200	9,600
In process, April 30	(1,000)	(360)
Total transferred out	7,000	9,440

Schedule A

Distribution of Department 101 Costs

	Dept. 201	Dept. 301
Sale price per lb.	$29.50	$17.50
Cost to process (subsequent to Department 101)	4.50	6.50
Net sales value at point of separation	$25.00	$11.00
1/3 of Department 101 production (14,400 lbs.)	4,800 lbs.	
Increase in Department 201 due to absorption of water	2,400	
	7,200 lbs.	
2/3 of Department 101 production (14,400 lbs.)		9,600 lbs.

Net sales value 201 production—7,200 × $25.00 =	$180,000
Net sales value 301 production—9,600 × 11.00 =	105,600
	$285,600
Allocation of Department 101 costs:	
To Department 201—$\frac{180,000}{285,600}$ × $219,912 =	$138,600
To Department 301—$\frac{105,600}{285,600}$ × $219,912 =	81,312
	$219,912

Schedule B

Equivalent Production for April

Department 201

Inventory March 31: 800 lbs. 50% complete		400 lbs.
Add: Production transferred from Department 101	4,800 lbs.	
Gain in weight in Department 201	2,400	7,200
		7,600 lbs.
Deduct inventory April 30—1,000 lbs. 50% complete		500
Equivalent production for April		7,100 lbs.

Department 301

Inventory March 31: 200 lbs. 50% complete	100 lbs.
Add production from Department 101	9,600
	9,700 lbs.
Deduct inventory April 30: 360 lbs. 50% complete	180
Equivalent production for April	9,520 lbs.

The Town Company

Summary of Inventories as of April 30

	Pounds	Per Pound	Amount
Work in process (cost of production statement)			
Department 201	1,000		$21,500.00
Department 301	360		4,219.20
Finished goods			
XO	800	$23.7443	18,995.44
MO	700	14.9696	10,478.72
Total			$55,193.36

Theory of Accounts

November 9, 1951; 1:30 to 5 p.m.

No. 1 (12½ points)

Whether the pricing of inventories under the "cost or market, whichever is lower" rule conflicts with the objective of matching appropriate cost against revenue depends on what the accountant is willing to include in cost. When market is below cost, the rule will result in charging against income a computed amount which represents a portion of the cost of goods still on hand. This computed charge is not related to the income of the period except in an indirect way, since it has no direct connection with the goods sold to produce income.

It may be argued that it was necessary to have an inventory in order to conduct the business and that any loss arising as a result of having such an inventory during an operating period is a proper charge to the income of that period. It would be argued that such a loss should be recognized whether it was due to obsolescence, destruction, or damage to the goods, or price level changes. (However, it should be noted that there is a difference in the status of damaged goods and goods for which there has been a market price decline. Price changes may be reversed. Price changes for materials may also be offset against other concurrent cost changes and they may or may not be reflected in the final sale price of the product.)

Supporters of the cost or market rule state that an inventory may be carried forward to the next accounting period provided it does not exceed an amount properly chargeable against the revenues expected to be obtained from ultimate disposition of the goods carried forward. They evidently wish to give the next period a "fresh start" and put it in the position of being no worse off than if it could purchase its inventories on the market. To some accountants this seems to be a recognition of something closely akin to "opportunity costs," which accountants generally refuse to recognize in the accounts. They state that the "fresh start" is not a reality and that the application of such a theory denies the assumption of "continuity of operations" under which accounting rules are formulated.

One of the principal exceptions to the rule that market declines should be recognized in the year of decline is to be found in the case of a raw material or other inventory item where the selling price of the finished product is not immediately responsive to changes in the price of the raw material. In such a case, if all of the finished product to be made out of inventories on hand can be sold at a profit, even when the cost of the product is determined on the basis of the old (and higher) price of the raw material, then no recognition needs to be given in the accounts to the decline in market price below cost, inasmuch as it will have no significant effect on the appropriate matching of cost against revenue.

A test of the value of any accounting practice lies in the effect of the formula on the usefulness of the financial statements. Each basis offers certain advantages, but the accountant must select one and only one pricing basis for his statements. With respect to the balance-sheet, the interest of short-term creditors is centered in this statement. Historically and currently, short-term creditors have stated their preference for inventory pricing at "cost or market, whichever is lower." In fact, the influence of creditors was probably instrumental in establishing the widespread use of this "conservative" method of inventory pricing. However, most accountants now

believe that an inventory method should be selected primarily by consideration of its effect on the income statement. Stockholders and prospective investors, long-term creditors, income-tax authorities and rate regulatory bodies are all primarily interested in the income statement.

From the point of view of the income statement, pricing inventories at "cost or market, whichever is lower" will take inventory losses before they are realized by sale and at any given date may show a lower total of historical earnings than if inventory were priced at cost. The same effect results from the use of the LIFO as opposed to the FIFO method of identifying cost during a period of rising prices. If a consistent method is used, trends may be studied and standards of judgment evolved. Therefore, consistency is also an important factor to be considered. On the grounds of consistency, pricing inventories at cost may be held to be as satisfactory as pricing inventories under the "cost or market" formula when considering only the income statement.

Under "cost or market" there is a switching from cost, which would be applicable during periods of rising or stable prices, to market during a period of falling prices. This switch from cost to market and back to cost is considered by some accountants to create inconsistency in the income statement. They hold that consistency requires exclusive use of cost or of market.

No. 2 (12½ points)

There are a great number of captions under which receivables may be shown on the balance-sheet. Common captions include the following:

1. Accounts receivable—trade.
2. Accounts receivable—officers, directors and employees.
3. Accounts receivable—subsidiaries.
4. Trade notes receivable.
5. Installment notes receivable.
6. Mortgage notes receivable.
7. Acceptances receivable.
8. Debit balances in suppliers' accounts.
9. Stock subscriptions receivable.
10. Dividends receivable.
11. Accrued income.
12. Claims receivable (such as claims for damages or tax refunds).
13. Advances to subsidiaries (or salesmen, etc.).
14. Miscellaneous receivables.

A number of captions for receivables will be used on the balance-sheet instead of a single caption whenever necessary to disclose significant information.

The different captions shown above indicate to the reader of the balance-sheet the ways in which the receivables arose, the evidence supporting the receivables, and whether or not the receivables are secured. They make possible the computation of various ratios useful in statement analysis and facilitate comparative analysis of statements. In addition, the captions permit the reader to infer something as to the likelihood of the receivables being contested, the time of collection, and whether settlement other than by cash collection is likely. Of course, further information is given by the inclusion or exclusion of the captions as current assets.

Materiality is the key to the number of captions used. Amounts large enough to be significant to the reader of the statement should be shown under separate captions.

No. 3 (12½ points)

The "reserve" section on the liability side of the balance-sheet may include three types of items. It may include liabilities in instances where the amount of the liability is indefinite and not determinable but is known to exist. This type of "reserve" ordinarily will have been created by a charge against income. The section may sometimes include amounts of income which have been deferred and it may include appropriations of surplus. Under current accepted practice it does not include "valuation reserves."

In general, elimination of the "reserves" section is a desirable change. Since a balance-sheet is presumably a statement of assets, liabilities, and proprietorship, there is very limited use in the fundamental accounting equation for an intermediate category. The reader of a balance-sheet should not be required to evaluate the financial need for any reported "reserves." The reader of the statement is not in nearly as good a position to determine the amounts of liabilities as are those who prepare the statement. There is an obligation to make the statements as informative as possible. Classification of a mixed group of items in this ill-defined section does not provide the reader with all the possible information. Lack of certainty does not prohibit nor excuse those who prepare statements from giving their best estimate of the situation.

The use of the word "reserve" is not considered to be good terminology. Therefore, elimination of the section involves two aspects. We must first determine the real nature of the provision and then we must use terminology which clearly describes the item. The "surplus reserves" are as much a part of retained earnings as is the nonappropriated portion. They can be clearly described and classified as a subdivision of retained earnings. Estimated liabilities can be described as estimates and be classified as liabilities. Deferred income amounts may require classification in a separate intermediate section, but they can be appropriately described for what they are.

The arguments against the elimination of the "reserve" section rest on practical grounds. There are uncertainties involved as to some of these items. Reclassification might give an appearance of certainty which is not warranted by the facts. In a few circumstances there may be a place for the "suspense" type of reserve. The close of an accounting period is an arbitrary division of the history of a company and some transactions may still be uncompleted and their final outcome uncertain. The reserves for contract renegotiation and post-war rehabilitation, which were so common immediately after the close of World War II, were perhaps of this type. It was simply impossible, in some cases, to tell just where the company stood at the date of the balance-sheet and, therefore, it was impossible to classify the reserve definitely unless classification was based on whether the amount was or was not an appropriation of retained earnings.

No. 4 (12½ points)

If income-tax regulations are not considered, the procedure is improper.

Cost is the accepted measure of "value" of assets in most situations because it is supportable by verifiable evidence and at the time cost is incurred, it logically

should be a reasonably satisfactory measure of value. However, after a considerable period has elapsed since acquisition, cost may no longer be a reasonable basis for determining value, but it will still be used because of the lack of any widely recognized and objective substitute. There is not verifiable evidence to support a change from the cost basis.

In the situation of the G Corporation, the value of the fixed assets rose substantially above the amount on the books as measured by the cost basis. However, this increase was not recognized in the accounts prior to the fire. Whether this increase in value was due to special circumstances or due to a general increase in price level is not significant. The result of the change in value which was not recognized has been that the income account was not being charged with the cost of using the building based on value as of the present date.

However, the occurrence of the fire, the collection of the insurance proceeds, and the construction of a new building changed conditions. Settlement with the insurance company provided an objective measure of the value of the building. The basis for recognizing gain was established and the additional test of realization was met by a change in the asset form from building to cash. At that point, the company must recognize the gain on the building. What happened thereafter to the cash has no bearing on the situation as to the old building.

The construction of a new building, no matter from what source it was financed, is a separate transaction. It is subject to the usual rule of "valuation at cash cost" and to the usual rule as to depreciation based on that cost.

The president's argument as to consistency indicates a misconception as to the meaning of consistency. In this particular situation, the company may have followed a policy of carrying its fixed assets at cost and of computing depreciation on cost. To consistently apply this policy, the cost of the new building needs to be recognized in the accounts and depreciation computed on such new cost. It is consistency as to maintenance of policy that is important—not consistency as to the amount of the charge to profit and loss. The amount charged to profit and loss is merely the end result of the cost policy. There is no substance to the president's argument that the amount of the charge to profit and loss should be the same for the current year as for prior years, except to the extent that the prior years' charges were not large enough based on the replacement value of the building. He should logically be proposing an adjustment of prior years' charges.

The president might have argued that, since the conversion was involuntary, the new building should be carried at the same remaining cost at which the old building was carried without recognition of this gain on conversion. However, the evidence for recognition of the gain is objective and verifiable and merits full recognition in the accounts.

No. 5 (12½ points)

Cost to manufacture is usually considered to include the sum of direct labor, direct materials, and applicable indirect factory costs. Consequently, by omitting indirect factory costs from work in process, the concern is understating inventory accounts in comparison with concerns which follow the usual practice. At any par-

ticular point of time, then, its financial position (balance-sheet) is incorrectly stated in the following particulars:

1. Work in process and finished goods are understated.
2. Current assets are understated, and so is its net working capital and the "current ratio."
3. Total assets are also understated.
4. Liabilities (debts) are not affected by this procedure, but net worth (proprietary equity) is understated, specifically in the earned surplus (retained earnings) account.

Of at least equal importance is the effect on the recorded results of operations. Unless the sum of work in process and finished goods accounts happens to be the same at each balance-sheet date, costs and revenues will not be matched in the usual manner, resulting in a corresponding distortion of reported net income. Thus, if these inventories at the end of the year exceed the corresponding totals at the beginning of that year, net profits will be understated; if the inventories are below those at the beginning of the year, the net profits will be overstated.

It is not accepted accounting practice to omit all factory overhead from inventories. While the cost of idle facilities, excessive spoilage, and certain other unusual items may be treated as period costs, the usual indirect costs are considered assignable to the production of the period.

These indirect costs are ordinarily not as easily assignable to products as are the direct costs, but at the time they are incurred, they are recoverable from future revenues. Therefore, where assignment to products is feasible they should be added to the direct costs and flow through inventories.

No. 6 (12½ points)

a. Accounting is utilitarian. Accounting statements are used as a basis for judgment and action. However, conventional accounting does not reflect all financial facts which would influence judgment and action as, for example, the signing of a contract. Sometimes the facts are uncertain and no quantitative measurement is possible. Sometimes the accounting procedures themselves, or changes in the procedures, must be explained to avoid misleading the users of statements.

In general, footnotes are desirable when supplementary information is necessary for proper understanding and interpretation of the financial statements. These notes give information about matters which are not reflected in the statements or information in elaboration of items which are included.

b. Examples of the information which may be disclosed by footnote:

1. Transactions and events which occurred after the date of the statements.
2. Contingent liabilities.
3. Accounting procedures, changes in accounting procedures and the effects of the changes.
4. Unusual commitments.
5. Other valuations than those used in the statements.
6. The basis of including subsidiaries in consolidated statements.
7. The basis of converting foreign currencies into American dollars.
8. Dividends in arrears on preferred stock.

9. Additional description or explanation of items in the statements.

c. Examples of information which might be contained in an auditor's long-form report but which would probably not appear in the financial statements or footnotes:

1. Detailed analysis or rearrangements of data shown on the statements. Sales may be classified by territories or principal customers; accounts receivable may be shown by age; inventories may be shown in detail.
2. Statistical information such as inventory quantities expressed in tons instead of in dollars.
3. A narration of the history of the client and the provisions of important contracts.
4. An analysis of insurance coverage.
5. Ratios, percentage statements, and comments.
6. A discussion of auditing procedures.
7. A discussion of minor changes in accounting procedures.
8. Recommendations for changes in the accounting system.
9. Application of funds statement or other similar statements.

No. 7 (12½ points)

a. Goodwill is an "intangible" asset, representing the capitalized value of the ability of a concern to make a more than normal rate of return on its present capitalization (or its capitalization adjusted for over or undervaluation of its net assets). Its existence is usually manifested by earning-power history in the recent past. However, earning power in the future is the basis for its valuation. Therefore, the recent financial history of the concern is usually adjusted or modified to reflect known or probable changes in revenues and expenses in the future.

b. All methods based on the existence of a rate of return in excess of the normal rate on the present capitalization require that several conditions be met prior to making actual computations. First, we must determine that the reported income is regular income or adjust it by eliminating extraneous profits or losses. Second, we must adjust expenses for management compensation, depreciation, etc., which appear to be unusual or not in line with the anticipated future amounts. Third, we should adjust for conditions as to products, contracts, etc., which may not be continued. Fourth, we should take into consideration any change in the basis on which tangible assets will be taken over. Fifth, we should adjust or consider the effects which changes in price level have had on profits. There may be other adjustments necessary in specific instances. The purpose is to arrive at an amount of profit which can be a guide to future profits.

This computed profit may be used in several ways to arrive at an amount of goodwill. Perhaps the method most consistent with the nature of goodwill is the determination of a normal rate or amount of return on the net assets used in the business. This amount is then subtracted from the average profits, as adjusted for extraneous items, etc., and the amount of above-normal profits determined. These profits may be capitalized at a rate sufficiently high to allow for the risk, thereby arriving at the amount of goodwill. This same amount of excess profits may also be used in another way to determine goodwill. An estimate may be made of the number of years such profits can be expected to continue and the present value of

such a series of future income receipts determined and used as the probable value of goodwill. A third variation using the same figure for excess profits results in the same figure as the capitalization and is merely a restatement of it in different terms. It is a statement of capitalization in terms of years' purchase of average excess profits. For instance, a five years' purchase of profits is the same as capitalization of profits at 20 per cent.

Other methods are sometimes used. One is to capitalize total profits and then deduct net assets from the amount so determined, thereby determining an amount for goodwill. A fifth method is to use an agreed number of years of past annual profits or past average profits as the amount of goodwill. These last two methods may or may not use adjusted profits in the computations.

c. All methods are subject to one basic limitation. There is no assurance that the past performance is a reliable guide to future performance, yet it is future profits which are of interest. The adjustments of past profits which have to be made under the first three methods described in (b) are based on judgment and are speculative in nature. Perhaps even more speculative is the estimate of the number of years for which above-normal profits will continue. The last two methods described have an additional fault. They do not utilize excess profits at all in the computation, but treat all profits as capitalizable at the same rate whether those profits arise from net tangible assets or from goodwill.

No. 8 (12½ points)

Mr. . . . ., Controller
The X Company
Dear Sir:

In computing federal income and excess-profits taxes at an interim accounting date when the total earnings of the current year are not known, it is not ordinarily satisfactory to compute the taxes on the actual profits earned to date. If the actual profits of your company to October 31, 1951, were used in accruing taxes, these profits would be taxed at the minimum existing rates, to the extent of the income in such brackets, and only the income over $75,000 would be subject to excess-profits taxes. Additional earnings of your fiscal year earned after October 31, however, would all bear the maximum tax rates, totaling —% of such income.

To avoid these results and to obtain a more significant net-income figure for the period, you should annualize income for the purpose of computing the taxes. Annualization would recognize that the income of the interim period should be taxed at the average rate at which the total income of the entire year will be taxed. Considering the year as a whole, the income of the first months should not be subject to the lowest rate of tax and the income of the last months should not bear the highest total rate.

The principle of annualizing may be applied in either of two ways. One is to estimate the profits for the remainder of the year, compute the estimated taxes for the full year, and prorate the total to the past months and to the future months on the basis of the income of each of the periods. The other method involves prorating the excess-profits-tax credit to the two periods in proportion to the profit of each

period and then computing the tax for the current period to October 31.

It is necessary to accept some estimate of the probable profits for the remaining portion of the year in order to annualize income. In determining probable income, it should be kept in mind that an overestimate of income will result in too large a tax being set up in this period, whereas an underestimate will result in the opposite condition.

No. 9 (12½ points)

1. Federal estate taxes paid are generally chargeable to principal.

2. Interest is considered to accrue in estate and trust accounting; therefore, any amount accrued at date of death of the testator would be chargeable to principal while that accruing after date of death would be charged against income.

3. Depreciation is not ordinarily provided for in connection with property held as part of a testamentary trust. The effect is to charge principal with any loss of useful life and value.

4. Legal fees for collection of current rent would be charged against income.

5. Special assessments levied for permanent improvements are charged to principal unless such improvements are shown to be of benefit to the income beneficiary.

6. Premium on bonds which were a part of the original estate assets need not be amortized. The result is that the premium is charged to principal when the bonds are collected at maturity. Generally the trustee is required to account for the assets turned over to him but need not maintain a fund of money unimpaired.

7. Losses (or gains) on the sale of trust assets are ordinarily charged to principal.

8. Carrying costs on non-productive property are usually considered to be a charge against principal. Presumably such property is held for the benefit of the remainderman.

No. 10 (12½ points)

a. A balance-sheet may be viewed as having two parts. One part is a listing of assets and the other part is a description of how the assets were obtained and how they may be used.

"Paid-in Surplus," "Undivided Profits," and "Reserve for General Contingencies" are descriptions of where the assets came from and something about their intended use.

"Capital Stock" together with "Paid-in Surplus" measures the amount of assets put into the corporation by stockholders in exchange for shares of the corporation's stock.

"Undivided Profits" together with the "Reserve for General Contingencies" measures the amount of assets obtained from profitable operations and not yet paid out in dividends to the stockholders. The "Reserve for General Contingencies" measures the amount which directors of the corporation consider desirable to retain in the business because of possible future losses. The remainder of the assets obtained from profitable operations may be paid out as dividends if the cash position and other financial considerations warrant.

Machinery and equipment are not useful forever. The "Reserve for Depreciation" is an approximation of the amount of asset cost which has been consumed up to the date of the balance-sheet. Since these assets will finally lose their value, a systematic reduction in value is reflected in the accounting statements.

b. Goodwill is an asset which cannot be precisely measured. How much goodwill does an advertising campaign develop? Since it cannot be measured, it is not usually recorded as an asset. However, if an entire business is purchased, a price for goodwill must be paid and the asset goodwill is then recorded. As time passes the increase or decrease in goodwill cannot be measured and the amount paid for goodwill in the past becomes inadequate as a measure of the goodwill which currently exists. Rather than use an inadequate measure, corporations frequently eliminate the goodwill from the list of assets shown on the balance-sheet. Sometimes it is written off over a period of two or three years instead of being eliminated from the list of assets all at once.

The "goodwill" shown on the balance-sheet does not measure the real goodwill of a business except perhaps immediately at the time of purchase of a going enterprise.

Auditing

November 8, 1951; 9 a.m. to 12:30 p.m.

No. 1 (10 points)

Lapping involves withholding cash received from an individual or source and covering such withholding by a subsequent entry. This covering entry creates a shortage as to some other customer or source of receipts and it in turn will be covered as was the first shortage. The result is a constant shifting of the shortage from each account to a more current account.

1951	*Actually Received from*	*Actual Cash Receipts*	*Recorded as Received from*	*Receipts Recorded and Deposited*	*Receipts Withheld*
November 1	Baker	$ 15	....	$ ..	$15
	Charles	20	Charles	20	
November 2	Jones	15	Baker	15	
	Smith	29	Smith	29	
November 3	Herbert	15	Jones	15	
	Neil	23	Neil	23	
		$117		$102	$15

No. 2 (12 points)

1. Review the internal control as to the acceptance of notes, the receipt and recording of cash collections, write-offs and adjustments.

2. Test the cut-off of sales at the year end and make tests of debits to notes arising from sales for a reasonable period.

3. Tie in credits to notes with cash receipts immediately before and after the balance-sheet date. If verification is not made at balance-sheet date, tie in transactions between date of verification and balance-sheet date. Test credits for a reasonable period during the year.

4. Test adjustments to the note account arising from return of merchandise, allowances and prepayments.

5. Check the company's deferral of interest and carrying charges and the deferral of gross income if it is deferred. Determine the consistency of the method followed with that followed in prior years.

6. Test computation of accrued interest and penalties arising from the notes.

7. Determine the adequacy of the provision for losses. Tie in write-offs to the reserve and test the write-offs for approval. Determine the accounting treatment of repossessions and test the entries.

8. Prove the totals of the subsidiary ledgers with the control account.

9. Confirm the notes with the makers on a test basis.

10. Examine the notes, paying attention to whether they have been properly filed or recorded as required by state law to preserve the rights against the property.

11. Confirm notes discounted with banks or finance companies, if any, and notes held by attorneys or others for collection.
12. Prepare or check the company's schedule of monthly maturities.
13. Investigate unusual items found as a result of the audit.

No. 3 (8 points)

a. No, the procedure is not effective. The signing officer cannot tell how many times the invoices have been submitted since all will be marked "paid" when he receives them. To be effective, the invoices should be marked "paid" at the time the checks are signed or immediately thereafter and before they leave the officer's control.

b. An auditor is concerned with the genuineness and the collectibility of the accounts receivable. The extended authority of the sales manager gives him an opportunity to have shipments made to himself in the name of a fictitious customer, and then to write off the fictitious account. Therefore, the auditor does not have as much assurance that the accounts are genuine as he would if there were a separate credit manager. Neither can the auditor rely on the sales manager's estimate of the collectibility of the receivables to the extent he could if there were a separate credit manager. This is true not only because of the possibility of fraud but also because the attitude of the sales manager might tend toward undue optimism. As a result the auditor must extend his procedures to be satisfied that the accounts are genuine and properly valued and that there has been no fraud.

No. 4 (10 points)

A complete picture of payroll activities is needed to determine the relationship between individual payroll procedures. Specifically the following additional information is needed:

1. Who hires and fires employees? It is a poor procedure to have foremen distribute the payroll. If the foremen also have the power to hire and fire, the door is opened wide for padding the payroll.
2. From what sources is the payroll prepared and is it subject to independent proof in total? If hours of work are reported by the foremen, there is the chance of deliberate misstatement. If there are clock cards, are they independent of control by the foremen? Can the payroll hours or dollars be checked in total to independent sources such as cost accounting records? If the payroll is prepared from unreliable sources and without any proof by totals, there is danger of error or fraud.
3. What controls exist for overtime and vacation pay? If adequate authorization and other controls are not provided, there is the danger of error or fraud in the payroll for these items.
4. What controls exist over changes in rates of pay? The absence of adequate controls here would create a danger of fraud or error.
5. Is a system of cost or budgetary control in operation? If so, what investigation of labor variances is made? An adequate investigation might disclose error or fraud.

6. What daily, weekly, or monthly payroll reports are prepared? A daily report of time worked, for example, might be sent to each foreman and to the plant superintendent. Any errors should be disclosed especially if the foremen and superintendent are held responsible under some kind of cost or budgetary control system.

7. Does the assistant treasurer return the signed checks to the accounting department or does he deliver them directly to the department foremen? If the checks are returned to the accounting department, there is danger of fraud since the chief accountant might be in a position to pad the payroll.

8. What disposition is made of unclaimed checks? Inadequate control would permit fraud.

9. Is there an internal auditing department, and if so, what are its procedures in connection with payroll? Since the chief accountant reconciles the payroll bank account, there would apparently be no one to know about or investigate dual endorsements of payroll checks, of which the second endorsement might be that of the chief accountant.

10. Are the W-2 statements of tax withheld mailed directly to employees by someone independent of the payroll system? Direct mailing of these statements affords some check on fraudulent payrolls if any unclaimed or undelivered statements are checked to determine the status of the employee.

No. 5 (10 points)

The figures show the following situation to exist:

Checks outstanding at balance-sheet date as determined from subsequent payments	$2,600
Checks held by paymaster	200
Total that should be in the bank	$2,800
Actual bank balance	2,300
Difference	$ 500

There are a number of possible explanations other than fraud, for the $500 discrepancy. Some possible explanations are:

1. The bank, at some time during the year could have charged the payroll account in error for checks drawn on one of the other accounts. This could be determined by going through the cancelled checks accompanying all bank statements for the payroll account for the year. It could also be suggested by a review of outstanding checks shown in the reconciliations of the other bank accounts.

2. Advance payroll checks or vacation checks could have been issued and entered in the payroll book but no deposit made until the regular payroll was entered, and the total payroll for the week determined. In this event, the account would actually be overdrawn. This would be determined by tracing to the payroll book the cancelled checks returned during the eight weeks subsequent to the balance-sheet, and comparing the dates of the checks with the dates of entry.

3. The facts could be explained by errors in drawing checks. A deposit could have been short of the total of some weekly payroll, or a payroll check could have been drawn for an amount in excess of the amount entered. These errors could be discovered by comparing amounts deposited with payroll totals and by comparing cancelled checks with amounts in the payroll book.

4. Replacements could have been drawn for lost payroll checks without stop-payment orders on the original checks having been issued.

If such replacement checks were not entered as cash disbursements, a comparison of checks returned subsequent to balance-sheet date with outstanding checks as of balance-sheet date should disclose the failure to stop payment as there would be two cancelled checks for one cash disbursement entry.

If the replacement checks were entered as cash disbursements, without the entry for the original check having been reversed, and if the replacement checks were not covered by a deposit, the bank account would be short. Such an omission could be located by checking to see if all the checks issued and entered are covered in a deposit.

In either case, a test should be made to see that stop-payment orders were issued for all checks for which replacements were drawn.

5. The payroll for the last pay period in the year may have been prepared and entered and the check for transfer of funds to the account drawn and reeorded but the transfer check not actually deposited until the following business day. This in-transit item could be verified by tying up inter-bank transfers thereby determining the actual date of deposit in the payroll bank account.

6. There is a possibility that the dates are wrong on some of the $2,600 of checks. Comparing all checks with the payroll record for the periods prior to balance-sheet date would disclose the existence of these checks. To establish that they should have been dated subsequent to balance-sheet date, they would have to be tied in with payrolls for the subsequent period.

No. 6 (20 points)

a. Balance, January 1, 1951—An analysis of the opening balance should be made and any necessary reclassification entries should be prepared to separate any portions of surplus arising from sources other than earnings.

Gain on sale of equipment—A first audit involves an analysis of the fixed-asset account and a determination of the accounting principles applied. Evidence supporting the original entry of the sold equipment should be examined. Accumulated depreciation should be verified. The entry recording the sale should be reviewed and supported by documents and entry of cash receipts.

Premium on sale of capital stock—When reading the certificate of incorporation, the authorized shares should be noted. When reading the minutes, authorization for the issuance of shares should be noted. The stock certificate book should be examined or confirmations obtained from the registrar and transfer agent. The cash received should be traced to the cash receipts book.

Reserve for income tax for 1951—The auditor should review the client's tax computations or make his own independent calculation of the tax liability taking into consideration the results of prior adjustments.

Dividends paid—The dividends should be related to the number of shares outstanding and checked for authorization in the minutes.

Pension payments to retired officer—The pension agreement should be examined and checked against authorization in the minutes. Tests might be made of the payments by tracing them to the cash disbursement record.

b. Balance, January 1, 1951—Analysis of this balance is necessary before it can be determined if any reclassifications are necessary.

Net income for the year—This is a proper credit to earned surplus (retained earnings).

Gain on sale of equipment—This is immaterial in amount and should be passed through the income statement instead of credited directly to surplus.

Premium on sale of capital stock—This is not an earned surplus credit and should be reclassified as paid-in surplus.

Reserve for income tax on 1951 income—This is apparently a charge for the estimated tax on 1951 income. It is a current year expense and should be shown in the income statement instead of charged directly to surplus.

Dividends paid—This is a proper charge to earned surplus, since it is a distribution of earnings.

Pension payments to retired officer—This should be shown as an expense in the current year's income statement. It is a regular recurring expense of the business.

No. 7 (15 points)

From the information given, the Pram Corporation apparently took a satisfactory physical inventory. There were no substantial differences between the client's count and the auditor's test counts. Differences between the count and the perpetual inventory records were also immaterial. There is no information given which would indicate that either the count or records are unreliable. Therefore, the auditor can accept the work done in connection with the physical inventory as of October 31. If the internal control is satisfactory, there is satisfactory evidence to support the balance-sheet inventory, as far as quantities are concerned, and generally accepted auditing procedures have been followed. December 31st work would be:

1. If not previously done, review internal control over inventory items and over perpetual records. Review the cost system in use.
2. In connection with the client's physical inentory at October 31, 1950, follow through the adjustment of perpetual records and investigate differences if these procedures were not followed at the time of the inventory tests.
3. If not done in connection with the October inventory, determine that the perpetual records are in balance with the controls.
4. Determine the method of pricing used by the company and test the accuracy of the prices as shown on the perpetual records.
5. If not done previously, make limited tests of footings and calculations of perpetual records.
6. Additional test counts of quantities may be made for large items or for items showing unusual changes.

7. Review the inventory control accounts, paying particular attention to entries made in the two months since October 31.

8. Check the cut-off of inventories at October 31 and December 31 as to receipts of raw materials, transfers in and out of work-in-process, and sales and shipments of finished goods. Make tests of entries for the two months ended December 31.

9. Compare inventory amounts with the prior year's and investigate unusual variations.

10. Discuss slow-moving or obsolete stock with company officials.

11. Obtain a representation letter from company officials for the December 31 inventories.

No. 8 (5 points)

a. Rule No. 9 of the Code of Ethics of the American Institute of Accountants reads, in part, as follows: "Professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service."

The principal purpose of the auditor's opinion or certificate is to add credibility to the financial statements prepared by business management. The added credibility stems from the public accountant's independent and disinterested position as an expert. It could hardly be said that the auditor was disinterested if his fee were to be a percentage of profits, or were otherwise related to the audit findings or results.

b. The auditor did not violate the rule of ethics. Professional fees are frequently and properly based on the time required to perform the services. Independence is not involved in such an agreement since the fee is not contingent on the results of the engagement.

No. 9 (10 points)

a. 1. The beneficiary of the policy, if not the client, may be a creditor. As is the case with a mortgage on buildings and equipment, the creditor may require insurance protection against the loss of the inventory which serves as collateral for the loan. The absence of a policy should suggest the possibility of the policy being held by a creditor.

2. Examination of insurance policies might reveal the retirement of assets in several ways. Policies may be cancelled when an asset is retired or sold. New policies may be taken out on replacements. The loss of an asset by fire may be indicated by a rider attached to the fire insurance policy. If an auditor, for example, matches an analysis of a truck account with the insurance policies on each truck, he might find discrepancies which would indicate the disposition of trucks without proper entry.

b. Excessive returns or allowances may indicate shipments made without customer's orders, shipments of defective merchandise, an attempt to cover misappropriation of assets, a misstatement of inventory or of sales and receivables, or weaknesses in the system of internal control. One purpose of a review of sales returns and allowances subsequent to the balance-sheet date is to uncover any facts which necessitate adjustment of inventories, receivables or sales in the statements being audited. Another purpose is to get data on internal control effectiveness.

Commercial Law

November 9, 1951; 9 a.m. to 12:30 p.m.

Group I

No. 1 (10 points)

a. 1. Future goods—goods to be manufactured or acquired by the seller after the contract to sell and without notice of the seller's defect of title. (Uniform Sales Act, Section 24.)

2. Fungible goods—goods of which any unit is from its nature or by mercantile usage treated as the equivalent of any other unit. (Uniform Sales Act, Section 76.)

3. Good faith purchaser—a purchaser for a valuable consideration paid or parted with in the belief that the vendor had a right to sell, with no knowledge or notice of rights of third parties. (Black, *Law Dictionary,* 3rd edition, p. 234.)

b. 1. Where specific goods form the contract of sale and these goods are wholly destroyed without the knowledge of the seller, at the time the agreement is made, the agreement is void.

2. In the same case, where the goods have been partially destroyed without the knowledge of the seller, the buyer may (a) avoid the sale or (b) take the remaining goods. If he does take the goods, he must pay the full contract price except that if the sale is divisible, the buyer pays only the proportionate contract price for the goods he receives. (Uniform Sales Act, Section 7(1) and (2).)

c. 1. The unpaid seller has a lien on the goods if the title is in the buyer and the seller keeps possession until payment, rescission, or resale. In addition, one of the following must be present: (a) Goods sold without credit stipulated. (b) The goods have been sold on credit but the credit term has expired. (c) The buyer has become insolvent. (d) The contract requires payment before delivery; i.e., C.O.D. (Uniform Sales Act, Section 54.)

2. The unpaid seller may stop the goods in transit when the buyer is or becomes insolvent. (Uniform Sales Act, Section 57.)

3. Where the goods are perishable; where the seller expressly reserves the right of resale in case the buyer should make default; or where the buyer has been in default in the payment of the price an unreasonable time an unpaid seller who has a right of lien or who has stopped the goods in transitu may resell the goods. (Uniform Sales Act, Section 60.)

No. 2 (10 points)

a. $5,000. In the absence of an agreement, partners share profits and losses equally even though they contribute unequal amounts of capital. (U.P.A. Section 18(a).)

b. Yes. Every partner is an agent of the partnership with authority to act for and bind the firm within the scope of the business, and the restriction on B's authority is ineffective unless X has knowledge of the restriction. (U.P.A. Section 9(1).)

c. 1. He forfeits any share of the goodwill when he wrongfully causes a dissolution. (Uniform Partnership Act, Section 38(2)(c)(II).)

2. He is liable for damages caused his partners by breach of the partnership agreement, and his share of the partnership assets is reduced accordingly. (Uniform Partnership Act, Section 38.)

No. 3 (10 points)

a. No. Where the holder of a check procures it to be accepted or certified the drawer and all prior indorsers are discharged from liability thereon. (Uniform Negotiable Instruments Act, Section 188.)

b. Yes. Since P endorsed the check *after* the acceptance by the bank he was not discharged from liability.

c. Yes. Where a check is certified by the bank on which it is drawn, the certification is equivalent to an acceptance. By its acceptance the bank engages that it will pay the check and becomes primarily liable thereon. (Negotiable Instruments Act, Sections 62 and 187.)

No. 4 (10 points)

a. The duties to be loyal; to obey instructions; not to be negligent; to account for the principal's money or property; and to inform the principal of facts that materially affect the agency. (2 American Jurisprudence "Agency" 251-290.)

b. The duty to employ and pay the agent compensation; the duty to reimburse the agent; and the duty to indemnify the agent. The principal also has a duty to give material information to the agent where failure to do so involves a possibility of physical harm or pecuniary loss to the agent.

c. 1. An agency coupled with an interest arises where an agent in addition to his authority is given an interest in the subject matter of the power (agency) itself and not merely in the proceeds which will arise from the exercise of the power. (2 American Jurisprudence, "Agency" Section 78.)

2. An independent contractor is one who, in exercising an independent employment, contracts to do certain work according to his own methods, and without being subject to the control of his employer, except as to the product or result of his work. (27 American Jurisprudence, "Independent Contractors," Section 2.)

3. Ratification is the affirmance by a person of a prior act which did not bind him but which was done or professedly done on his account, whereby the act, as to some or all persons, is given effect as if originally authorized by him. (Restatement of the Law of Agency Section 82.)

4. Ostensible authority is that which, though not actually granted, the principal knowingly permits the agent to exercise, or which he holds the agent out as possessing. Accordingly, an ostensible agent is one who, with or without authority, reasonably appears to third persons to be authorized to act as the agent of another. (2 American Jurisprudence, "Agency" Section 101; Restatement of the Law of Agency, Section 8.)

5. Election or election of remedies refers to the choice of one from among a number of alternative methods of enforcing certain liabilities. In the law of agency such an election arises when the existence or identity of a previously undisclosed principal becomes known to the third person. In such a case the third person has the choice of obtaining recovery from either the agent or the principal. If the third person looks only to the agent or only to the principal for payment or performance,

the other is not discharged. But if (and when) the third person obtains satisfaction from the agent or the principal, or recovers a judgment against the agent or the principal, the other is discharged. (Restatement of the Law of Agency, Sections 209, 210, 211, 320, 321, 337.) A principal also has an election of remedies with respect to an agent's violation as threatened violation of his duties. (Restatement of the Law of Agency, Section 399.)

No. 5 (10 points)

a. The surety is a party to an original obligation which binds him as well as his principal, where as a guarantor is not a party to such an undertaking, the contract by which a guarantor is bound being collateral to a primary or original obligation. (24 American Jurisprudence, "Guaranty" Section 11.)

b. 1. In absence of express authority or unless it is reasonably necessary to its authorized business, a corporation may not become a surety. (6 Fletcher, Cyclopedia Corporations, 2587, 2588, 2591.)

2. A partnership may contract as surety, but one partner acting alone could not obligate the firm unless such a contract would be within the implied powers of the partner in carrying on the business. (40 American Jurisprudence, "Partnership" 156; 24 American Jurisprudence, "Guaranty" Section 30.)

c. 1. "Valid tender of payment of a debt will relieve the debtor of further interest on his debt and from further costs if sued by the creditor for nonpayment. It will also release most liens given to secure the debt, although there is a conflict of authority on this point as to the effect on a mortgage due largely to a difference of opinion as to the legal effect of the mortgage instrument. Tender alone will not release the lien of a judgment. (52 American Jurisprudence, 'Tender' Sections 39, 40, 43.)"

2. A valid tender of payment discharges the surety. (50 American Jurisprudence, "Suretyship," Section 116.)

d. 1. Yes, if the obligation is joint and several. In most cases the surety contract is worded so that the undertaking will be construed as both joint and several in which case action will lie against any surety for the full amount. (Restatement of the Law of Contracts, Section 116.)

2. Yes. The surety agrees to become liable in event the debtor does not pay his debt at maturity, and in absence of a specific qualification, the presence of other sureties or other security does not affect the surety's liability. The fact that the creditor holds collateral security pledged to pay the debt does not entitle the surety to insist that the creditor look first to the collateral as the surety can protect himself by paying the claim and becoming subrogated to the creditor's rights in the collateral. (50 American Jurisprudence, "Suretyship," Section 257.)

Group II

No. 6 (10 points)

a. 1. The defense of infancy would not be good. Ratification is generally a question of intention, but the intent to ratify need not be expressly declared. The intent to ratify may be inferred from the free and voluntary acts of the party. If

the party to be charged acts in a manner inconsistent with any other purpose than ratification, he will be held. If, after attaining his majority, he retains, for an unreasonable time, property purchased while an infant or if he exercises acts of ownership over the property which are inconsistent with an intent to disaffirm the contract, he will have ratified the contract. In this case the sale of the property after attaining majority justifies a finding that the infant had ratified the contract. (Hilton v. Shepherd, 912 Me. 160, 42 A, 387 (1898); 27 Am. Jur. 806 S 81; Ann. Cas. 1917 D) (1 Williston Section 239, page 7).

2. The defense of the statute of limitations would be good. The statute begins to run when the cause of action accrues. In this case the first default occurred three months after Sam purchased the bicycle, and the entire balance was due and payable within seven months thereafter. More than six and one-half years had elapsed after the final payment was due before suit was brought. The fact that Sam was an infant would not stay the running of the statute of limitations. Wells saw an adult and not under disability and could have sued Sam on the claim at any time after default. The practice generally followed, if the infant is not under guardianship, is to bring suit and to have a guardian ad litem appointed for the infant. (34 American Jurisprudence, Page 158, Section 197; 1 Williston on Contracts, Section 239).

b. 1. The defense of infancy would not be good. Sam's promise to pay the balance of the purchase price of the bicycle would be equivalent to an express ratification. Further, the keeping of the bicycle for six months after he became of age would be strong evidence of an intention to ratify the contract. The promise to pay coupled with the keeping of the bicycle would be almost conclusive evidence of his intention to ratify. (27 American Jurisprudence, "Infants," Section 78; Restatement of the Law of Contracts, Section 86.)

2. The defense of the statute of limitations is not good. Sam's promise, which was made after the running of the statute of limitations, to pay the unpaid balance of the purchase price of the bicycle would be considered as a new promise, and this promise is enforceable until the statute has run against it. Suit was brought shortly after the cause of action on the new promise accrued. (34 American Jurisprudence, Pages 242, Section 300) (54 Corpus Juris Secundum, Page 375, Section 307.)

No. 7 (10 points)

a. Cumulative preferred stock entitles the holders to receive dividends in arrears, in addition to subsequent dividends, out of the profits of subsequent years, before any dividends can be paid to the holders of common stock. (12 Fletcher, Cyclopedia Corporations, Section 5447.)

b. Participating preferred stock shares with the common stock in surplus available for dividends after preferred and common stocks have received a like dividend for the current year. (12 Fletcher, Cyclopedia Corporations, Section 5448.)

c. No par stock is stock which does not state on its face a "par value" meaning the amount of money or property originally paid in for the stock. (11 Fletcher, Cyclopedia Corporations, Section 5127.)

d. A pre-emptive right is the right given a stockholder in a corporation to have first chance to purchase enough stock in a new stock issue of the corporation to maintain his present proportionate interest in the corporation. (11 Fletcher, Cyclopedia Corporations, Sections 5135, 5136.)

e. In voting for directors, a stockholder generally has as many votes as his number of shares multiplied by the number of directors to be elected would total. Cumulative voting allows the stockholder to cast all his votes for one director or to split his votes among directors as he sees fit. (Stevens, R. S. Private Corporations, Hornbook Series, Page 463, Section 117.) Black *Law Dictionary,* Third Edition, Page 489.)

No. 8 (10 points)

a. Yes, provided H called C before the close of business hours, if he called him at his office or before the usual hour of rest, if he called him at his residence.

b. Yes, provided H called C before the close of business hours, if he called him at his office, or before the usual hour of rest, if he called him at his residence.

c. Yes. B had the same time to notify A, that C had to notify B. Notice by mail should be sent in time to reach the endorser on the day following the notice to the sender of the letter. This was done. The fact that the letter was received a week later does not invalidate the notice as the act provides that if the notice is properly mailed, it is *conclusively* presumed to have been received. (Negotiable Instruments Act, Section 103(3), 107, 105.)

d. Yes. A proper notice of dishonor given by any party on the instrument, is effective for the benefit of the holder and all parties subsequent to the party notified. H could recover from B by virtue of C's notice, and from A by virtue of B's notice. (Negotiable Instruments Act, Section 93.)

No. 9 (10 points)

a. Sec. 14(c) of the Bankruptcy Act provides as follows: "The court shall grant the discharge unless satisfied that the bankrupt has:

1. committed an offense punishable by imprisonment as provided under Title 18 United States Codes, Sec. 152; or

2. destroyed, mutilated, falsified, concealed, or failed to keep or preserve books of accounts or records from which his financial condition and business transactions might be ascertained, unless the court deems such acts or failure to have been justified under all the circumstances of the case; or

3. obtained money or property on credit, or obtained an extension or renewal of credit, by making or publishing . . . a materially false statement in writing respecting his financial condition . . .; or

4. at any time subsequent to the first day of the twelve months immediately preceding the filing of the petition in bankruptcy transferred, removed, destroyed, or concealed, or permitted to be removed, destroyed, or concealed, any of his property, with intent to hinder, delay, or defraud his creditors; or

5. has within six years prior to bankruptcy been granted a discharge . . . under this act; or

6. in the course of a proceeding under this act refused to obey any lawful order of or to answer any material question approved by the court; or

7. has failed to explain satisfactorily any losses of assets or deficiency of assets to meet liabilities."

Sec. 14(e) says, if the bankrupt fails to appear for examination, without cause, at the first meeting of creditors, he waives his right to a discharge.

b. Sec. 17 of the Act reads as follows: "A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as:

1. are due as a tax levied by the United States, or any state, county, district, or municipality; or

2. are liabilities for obtaining money or property by false pretenses or false representations, or for willful and malicious injuries to the person or property of another, or for alimony, maintenance, or support—seduction—breach of promise accompanied by seduction or for criminal conversation . . .; or

3. have not been duly scheduled in time for proof and allowance, with the name of the creditor, if known to bankrupt, unless the creditor had notice or actual knowledge of the proceedings in bankruptcy; or

4. were created by his fraud, embezzlement, misappropriation, or defalcation while acting as an officer or in any fiduciary capacity; or

5. are for wages which have been earned within the three months before the date of commencement of the proceedings in bankruptcy (by) workmen, servants, clerks . . .; or

6. are due for moneys of an employee received or retained by his employer to secure the faithful performance by such employee of the terms of a contract of employment."

c. In general, a creditor who has knowingly received a preference within the immediate four months preceding the filing of the petition in bankruptcy takes subject to the right of the trustee to avoid, unless he extend additional credit in good faith without security. Any lien obtained by court action against a debtor's property within the four months immediately prior to bankruptcy is void if the debtor was insolvent at the date the lien was obtained. This is true even though the creditor was unaware of the debtor's insolvency. (See Sections 60 and 67 of the Act.)

No. 10 (10 points)

1. Green transferred his agreement, not his option, to purchase the property. A purchaser under a written contract for the sale of land is usually considered to hold an equitable title to the land and an agreement to assign such an interest is, as a general rule, within the statute of frauds. Some courts have held that such an interest is merely a personal right which may be assigned without writing. (49 American Jurisprudence, "Statute of Frauds," Section 214.)

2. An agreement to form a corporation which is to take title to land is an agreement to procure a purchaser for an interest in land, not an agreement to purchase the land. Therefore it is not within the Statute of Frauds and need not be in writing. (Restatement of the Law of Contracts, Section 194(2).)

3. An agreement to repurchase stock if its market value declines is not a promise to answer for the default of a third person, since the corporation is not under a contractual obligation to maintain the market value of its stock. Such a promise may be performed within one year from the making thereof, since the duty to repurchase is made conditional; and since the event may happen within a year of the making of the contract, the promise need not be in writing. (49 American Jurisprudence, "Statute of Frauds," Sections 31, 104.)

4. R did not promise to employ Green for five years but did promise to cause the corporation to employ Green for that period. This agreement can be performed by both R and Green within one year since all that is required for the performance of this agreement is that the proposed corporation and Green enter into the contract of employment. The contract of employment entered into by the corporation and Green, to be enforceable, would have to be in writing. (Restatement-Contracts, Section 198, Coughlin v. McGrath, 295 Mass. 499, 4 N. E. 2nd 319 (1936); Cunningham v. Holzmark, 225 Mo. App. 762, 37 S. W. 2d 956 (1931).)

No. 11 (10 points)

1. True—1 Bogert, Trusts and Trustees, Section 43.
2. False—1A Bogert, Trusts and Trustees, Section 150.
3. True—1 Bogert, Trusts and Trustees, Section 129; Restatement of the Law of Trusts, Section 100.
4. False—Restatement of the Law of Trusts, Section 114; 1 Bogert, Trusts and Trustees, Section 43.
5. True—4 Bogert, Trusts and Trustees, Section 994.
6. False—3 Bogert, Trusts and Trustees, Sections 471, 472.
7. True—2 Bogert, Trusts and Trustees, Section 362.
8. True—3 Bogert, Trusts and Trustees, Section 596; Restatement of the Law of Trusts, Section 179.
9. True—3 Bogert, Trusts and Trustees, Section 712; Restatement of the Law of Trusts, Sections 262, 263.
10. False—4 Bogert, Trusts and Trustees, Section 1002; Restatement of the Law of Trusts, Section 337.

No. 12 (10 points)

1. True—29 American Jurisprudence, "Insurance," Section 355.
2. True—29 American Jurisprudence, "Insurance," Sections 305, 306.
3. False—Section 70(5) of the Bankruptcy Act.
4. True—29 American Jurisprudence, "Insurance," Section 884.
5. False—29 American Jurisprudence, "Insurance," Section 669.
6. True—29 American Jurisprudence, "Insurance," Section 1181.
7. False—29 American Jurisprudence, "Insurance," Section 1192.
8. False—29 American Jurisprudence, "Insurance," Section 1346.
9. True—29 American Jurisprudence, "Insurance," Section 361.
10. False—Carpenter v. Insurance Company, 16 Pet. 495 (U.S. 1846); Baker v. Monumental Savings and Loan Association, 58 W. Va. 408, 52 S.E. 403 (1905).

Examination Answers, May, 1952

Accounting Practice — Part 1

May 14, 1952; 1:30 to 6 p.m.

No. 1 (12 points)

JOURNAL ENTRIES

		Debit	Credit
a.	Cash	$996,666.67	
	Unamortized discount on bonds	20,000.00	
	Bonds payable		$1,000,000.00
	Accrued bond interest		16,666.67
	To record sale of $1,000,000 of bonds at 98 and accrued interest.		
	Unamortized discount on bonds	8,320.00	
	Cash (or payables)		8,320.00
	To record cost of bond issue.		
b.	Accrued bond interest	$ 25,000.00	
	Cash		$ 25,000.00
	To record payment of six months interest on $1,000,000 of 5% bonds.		
c.	Amortization of bond discount	$ 120.00	
	Unamortized discount on bonds		$ 120.00
	Interest on bonds	4,166.67	
	Accrued bond interest		4,166.67
	To adjust books for December.		
	Profit and loss	51,440.00	
	Amortization of bond discount		1,440.00
	Interest on bonds		50,000.00
	To close expense accounts for 1949.		
d.	Bonds payable	$ 20,000.00	
	Accrued bond interest	416.67	
	Unamortized bond discount		$ 520.80
	Common stock		12,000.00
	Paid-in surplus		7,479.20
	Cash		416.67

To record payment of five months interest on $20,000 of bonds, the conversion of $20,000 of bonds into 120 shares of common stock and the write-off of the unamortized discount applicable to the bonds converted.

Computation of discount write-off:

Original discount		$28,320.00
Amortized 1948	$ 720	
Amortized 1949	1,440	
Amortized January 1950	120	2,280.00
Balance		$26,040.00
2% of balance applicable to bonds converted		520.80

		Debit	Credit
e.	Interest on bonds	$ 4,083.33	
	Accrued bond interest		$ 4,083.33
	Amortization of bond discount	117.60	
	Unamortized discount on bonds		117.60
	To adjust books for December.		
	Profit and loss	50,496.93	
	Amortization of bond discount		1,413.60
	Interest on bonds		49,083.33
	To close expense accounts for 1949.		

ANALYSIS OF UNAMORTIZED BOND DISCOUNT AND EXPENSE ACCOUNT

Date		Debit	Credit	Debit Balance
6/30/48	Discount on sale	$20,000		$20,000.00
6/30/48	Expenses of sale	8,320		28,320.00
6/30 to 12/31/48	Amortization at $120 per month		$ 720.00	27,600.00
1/1 to 12/31/49	Amortization at $120 per month		1,440.00	26,160.00
1/31/50	Amortization for one month		120.00	26,040.00
2/1/50	Write-off of discount and expense on bonds converted		520.80	25,519.20
2/1 to 12/31/50	Amortization at $117.60 per month		1,293.60	24,225.60

No. 2 (18 points)

A. B. C AND D—SUMMARY STATEMENT OF INCOME AND EXPENSE

	Six months ended				
	6-30-50	12-31-50	6-30-51	12-31-51	Total
Sales (net of losses on account)	51,000	170,000	255,000	374,000	850,000
Cost of goods sold	35,700	127,500	204,000	299,200	666,400
Gross profit	$15,300	$ 42,500	$ 51,000	$ 74,800	$183,600
Operating expenses:					
Rents, etc.	$ 8,820	$ 8,820	$ 8,820	$ 8,820	$ 35,280
Other expenses	4,200	14,000	21,000	30,800	70,000
Total	$13,020	$ 22,820	$ 29,820	$ 39,620	$105,280
Net profit	$ 2,280	$ 19,680	$ 21,180	$ 35,180	$ 78,320

ANALYSIS OF CHANGES IN PARTNERS' CAPITAL

	A	B	C	D	Total
Investment 1/1/50	$20,000.00	$30,000.00	—	—	$50,000
Profit for six months ended 6/30/50	1,140.00	1,140.00	—	—	2,280
Withdrawals	(1,800.00)	(1,800.00)	—	—	(3,600)
Balance 6/30/50	$19,340.00	$29,340.00			$ 48,680
Investment 7/1/50	—	—	$25,000.00	—	25,000
Profit for six months ended 12/31/50	6,973.75	6,973.75	5,732.50	—	19,680
Withdrawals	(1,800.00)	(1,800.00)	(1,800.00)	—	(5,400)
Balance 12/31/50	$24,513.75	$34,513.75	$28,932.50		$ 87,960
Investment 1/1/51	—	—	—	$12,000	12,000
Profit for six months ended 6/30/51	5,929.00	5,929.00	5,036.00	4,286	21,180
Withdrawals	(1,800.00)	(1,800.00)	(1,800.00)	(1,800)	(7,200)
Balance 6/30/51	$28,642.75	$38,642.75	$32,168.50	$14,486	$113,940
Profit for six months ended 12/31/51	$10,129.00	10,129.00	7,836.00	7,086	35,180
Withdrawals	(1,800.00)	(1,800.00)	(1,800.00)	(1,800)	(7,200)
Balance 12/31/51	$36,971.75	$46,971.75	$38,204.50	$19,772	$141,920

A, B, C AND D BALANCE-SHEET DECEMBER 31, 1951

Assets

Cash	$ 33,121
Accounts receivable	40,000
Merchandise inventory	83.084
Total	$156,205

Liabilities and Capital

Accounts payable	$ 14,285
Partners' capital balances	141,920
Total	$156,205

COMPUTATION OF SALES AND COST OF GOODS SOLD

	Six months ended				
	6-30-50	*12-31-50*	*6-30-51*	*12-31-51*	*Total*
Collections to 6/30/50	$36,600	—	—	—	$ 36,600
Collections to 12/31/50	6,200	$124,200	—	—	130,400
Collections to 6/30/51	4,100	34,500	$192,500	—	231,100
Collections to 12/31/51	2,500	8,200	53,900	$347,300	411,900
Total cash from sales	$49,400	$166,900	$246,400	$347,300	$810,000
Balance of receivables	1,600	3,100	8,600	26,700	40,000
Total collectible sales	$51,000	$170,000	$255,000	$374,000	$850,000
Percentage of cost to sales	.70	.75	.80	.80	
Cost of goods sold	$35,700	$127,500	$204,000	$299,200	$666,400
Payment on purchases				$742,498	
Accounts payable				14,285	
Total purchases				$756,783	
Inventory 12/31/51				83,084	
Actual cost of goods sold					673,699
Shortage in computed cost (to be charged as other expenses)					$ 7,299

SCHEDULE OF DISTRIBUTION OF PROFIT

	A	*B*	*C*	*D*	*Total*
Salary allowances to 6/30/50	$ 4,000.00	$ 4,000.00			$ 8,000
Remaining profits to 6/30/50	(2,860.00)	(2,860.00)			(5,720)
Salary allowances—6/30/50 to 12/31/50	4,000.00	4,000.00	$ 3,750.00		11,750
Remaining profits—6/30/50 to 12/31/50	2,973.75	2,973.75	1,982.50		7,930
Salary allowances—1/1/51 to 6/30/51	4,000.00	4,000.00	3,750.00	$ 3,000	14,750
Remaining profits—1/1/51 to 6/30/51	1,929.00	1,929.00	1,286.00	1,286	6,430
Salary allowances—6/30/51 to 12/31/51	4,000.00	4,000.00	3,750.00	3,000	14,750
Remaining profits—6/30/51 to 12/31/51	6,129.00	6,129.00	4,086.00	4,086	20,430
Total	$24,171.75	$24,175.75	$18,604.50	$11,372	$78,320

No. 3 (20 points) (Optional with No. 4)

JUNE 30, 1949 ENTRIES

Common stock—S. Co.	$280,000	
Paid-in surplus—S. Co.	59,440	
Retained earnings—S. Co.	34,996	
Excess of cost of stock acquired over book value of stock	20,364	
Investment in S-P Corporation		$394,800

To eliminate the investment on books of P Corporation against the stock, paid-in surplus and retained earnings represented thereby.

Common stock—S Co.	50,000	
Treasury stock—S. Co.		50,000

To eliminate Treasury Stock of S. Co.

COMPUTATIONS

Interest of P in S—$\frac{2800}{3500} = .8$

	Per Books	Eliminate	Minority
.8 of Capital stock outstanding	$350,000	$280,000	$ 70,000
.8 of Paid-in surplus	74,300	59,440	14,860
.8 of Retained earnings	43,745	34,996	8,749

DECEMBER 31, 1951 ENTRY

Common stock—S. Co.	$350,000.00	
Paid-in surplus—S. Co.	100,012.50	
Retained earnings—S. Co.	40,803.25	
Excess of cost of stock acquired over book value of stock	28,984.25	
Investment in S-P Corporation		$519,800

To eliminate the investment on books of P Corporation against the stock, paid-in surplus and retained earnings represented thereby.

Remaining balances of S. Co. stock and surplus is minority interest except for $34,298.00 of retained earnings. This is made up of 4/5 of the increase in retained earnings from June 30, 1949 to January 1, 1951, amounting to $24,848, and 6/7 of the increase in retained earnings during 1951, amounting to $9,450.

COMPUTATIONS

	Per Books	(1/8) Minority	Consolidated Retained Earnings	Eliminations
Capital stock	$400,000	$50,000.00	—	$350,000.00
Paid-in surplus	114,300	14,287.50	—	100,012.50
Retained earnings	85,830	10,728.75	$34,298	40,803.25
Total	$600,130	$75,016.25	$34,298	$490,815.75
Cost of investments				519,800.00
Excess of cost over book value				$ 28,984.25

The consolidated retained earnings shown above consists of .8 of the $31,060 increase in retained earnings from date of acquisition of the 2,800 shares to December 31, 1950, amounting to $24,848, and 6/7 of the $11,025 increase in retained earnings during 1951, amounting to $9,450.

ALTERNATE COMPUTATIONS

(Not required of the candidate if the preceding computations are made)

Acquisition of 200 Outside Shares		
Cost		$35,000.00
Interest acquired (2/35):		
In stock	$20,000.00	
In 1/1/51 paid-in surplus	4,245.71	
In 1/1/51 retained earnings	4,274.57	28,520.28
Excess of cost over book value		$ 6,479.72

Acquisition of 500 Shares of Treasury Stock		
Cost		$90,000.00
Interest acquired (1/8):		
In stock	$50,000.00	
In 12/31/51 paid-in surplus	14,287.50	
In 12/31/51 retained earnings	10,728.75	75,016.25
Excess of cost over book value		$14,983.75*

Adjustment as a result of effect of Treasury Stock acquisition on former purchases:		
Portion of present interest in paid-in surplus applicable to former purchases—3/4 of $114,300	$85,725.00	
Former interest in paid-in surplus—6/7 of $74,300	63,685.71	
Decrease in "Excess of Cost over Book Value"	($22,039.29)	
Portion of present interest in retained earnings applicable to former purchases—3/4 of $85,830	$64,372.50	
Former interest in retained earnings—6/7 of $85,830	73,568.57	
Increase in "Excess of Cost over Book Value"	$ 9,196.07	
Net decrease		$12,843.22
Effect of Treasury Stock acquisition		$ 2,140.53*
Former "Excess of Cost over Book Value"		26,843.72
Present "Excess of Cost over Book Value"		$28,984.25

* The acquisition of stock held in the treasury of a subsidiary company affects the relative per cent the prior holding represents of total outstanding stock. Therefore, the computation of "goodwill" must take account of the effect of the transaction on existing holdings. This computation might be made in terms of the minority interest or in terms of the parent's interest. The previous computation was in terms of the parent's interest.

* The net effect on "Excess of Cost over Book Value" of the acquisition of Treasury Stock is $2,140.53. This amount can result only from the transaction affecting the minority interest since the remaining part of the transaction is with the parent's own interest in the subsidiary. The effect on the minority interest can be established as follows:

Minority interest before Treasury Stock transaction:	
1/7 of Paid-in Surplus of $74,300 =	$10,614.29
1/7 of Retained Earnings of $85,830 =	12,261.43
Total	$22,875.72

Minority interest after Treasury Stock transaction:	
1/8 of Paid-in Surplus of $114,300 =	$14,287.50
1/8 of Retained Earnings of $ 85,830 =	10,728.75
Total	$25,016.25
Net increase in minority interest	$ 2,140.53

No. 4 (20 points) (Optional with No. 3)

LEDGER ACCOUNTS

Inventory of Raw Materials

3/31 Balance	$10,485.90	April issues	$3,432.10
April purchases	3,619.98		

Price Variation—Materials

3/31 Balance	$ 723.55	Adjustment (net)	$ 236.79
April purchases	249.73		

Work in Process—Materials

3/31 Balance	$ 770.80	April—to finished goods	$3,111.00
April charges	3,432.10	Adjustment—quantity	419.15
Adjustment—price	42.99	Adjustment—price, 1st of month	49.78

Work in Process—Labor

3/31 Balance	$ 731.15	April—to finished goods	$4,641.00
April charges	4,668.79	Adjustment	148.51

Finished Goods

April—from W. in P.—Materials	$ 3,111.00		
April—from W. in P.—Labor	4,641.00		
Material excess	419.15		
Material price	243.58		
Labor excess	148.51		

ADJUSTING ENTRIES

	Debit	Credit
Finished goods	$419.15	
Work in process—materials		$419.15
To apportion excess material used between work in process and finished goods.		
Finished goods	243.58	
Work in process—material	42.99	
Price variation—materials		236.79
Work in process—material		49.78
To apportion price variation among the three accounts involved.		
Finished goods	148.51	
Work in process—labor		148.51
To transfer the portion of excess labor cost applicable to units completed during the month.		

COMPUTATIONS

Allocation of Excess Material Used

Estimated cost of material in process—4/30/52:		
50 units 30% complete @ $6.10	$ 91.50	
100 units, 75% complete @ $6.10	457.50	
Total estimated cost of material in process based on units at estimated price	$ 549.00	
Actual balance of material in process account		$ 1,091.90
Amount of price variation included		49.78
Balance of material at estimated price		$ 1,042.10
Estimated quantity in process at estimated price		549.02
Excess quantity at estimated price		$ 493.12

Allocation of quantity excess:

Material to finished goods	$ 3,111.00	
Material in process	549.00	
Basis for apportionment	$ 3,660.00	
To finished goods $\frac{3,111}{3,660} \times \$493.12 =$		$ 419.15
To material in process $\frac{549}{3,660} \times \$493.12 =$		$ 73.97

Allocation of Material Price Variation

Amount of variation in material in process		$ 49.78
Amount of variation in price variation account		973.28
Total to be apportioned		$ 1,023.06
Basis for apportionment:		
Material in inventory at estimated price		$10,673.78
Material in process—estimated amount	$ 549.00	
Material in process—excess amount	73.97	622.97
Material finished—estimated amount	$ 3,111.00	
Material finished—excess amount	419.15	3,530.15
		$14,826.90
To material inventory $\frac{10,673.78}{14,826.90} \times \$1,023.06 =$	$ 736.49	
To work in process $\frac{622.97}{14,826.90} \times \$1,023.06 =$	$ 42.99	
To finished goods $\frac{3,530.15}{14,826.90} \times \$1,023.06 =$	$ 243.58	

Allocation of Labor Variation

Estimated cost of labor in process:	
50 units, 10% complete @ $9.10 =	$ 45.50
100 units, 60% complete @ $9.10 =	546.00
Total estimated cost	$ 591.50
Estimated cost of units completed— 510 units $9.10	$ 4,641.00
Excess cost ($758.94 less $591.50)	$ 167.44
Allocation:	
To finished goods $\frac{4,641.00}{5,232.50} \times \$167.44 =$	$ 148.51
To work in process $\frac{591.50}{5,232.50} \times \$167.44 =$	18.93
	$ 167.44

Accounting Practice — Part II

May 15, 1952; 1:30 to 6 p.m.

No. 1 (15 points)

a. 1. (b) False	7. (b) False	b. 1. (d) $3,600	3. (a) 0	d. 1. (a) Yes	7. (a) Yes
2. (a) True	8. (b) False	2. (c)	(b) $2,000	2. (a) Yes	8. (b) No
3. (b) False	9. (a) True	3. (b) 0	4. (a) 0	3. (b) No	9. (a) Yes
4. (b) False	10. (a) True	4. (d) 0	(b) $11,100	4. (b) No	10. (b) No
5. (a) True	11. (a) True	c. 1. (a) 0	5. (a) $3,000 loss	5. (b) No	11. (a) Yes
6. (a) True	12. (a) True	(b) $2,800	(b) $12,000	6. (b) No	12. (b) No
		2. (a) $300			
		(b) $1,800			

No. 2 (10 points)

SCHEDULE SHOWING BREAK-EVEN VOLUME BY MODELS

Model Number	*Net Sales Price*[1]	*Variable Cost*	*Amount Per Unit Available For Non-Variable*	*Budgeted Non-Variable Cost*[2]	*Number of Units To Meet Cost*	*Sales Price*	*Sales Required To Break Even*
100	$14.958	$ 9.871	$5.087	$158,630.50	31,183	$15	$467,745
200	17.970	10.250	7.720	106,275.00	13,766	18	247,788
300	24.959	15.436	9.523	83,200.00	8,737	25	218,425

1 Sales price less average allowance per unit.

2 Budgeted production multiplied by estimated non-variable unit cost.

No. 3 (Part a) (25 points)

M & N—WORKSHEET FOR HOME OFFICE

Four months ended October 31, 1951

	Transactions		*Adjustments*		*Profit and Loss*		*Balance-Sheet*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash—h. o.	$ 56,397(1)	$ 78,356(2)					$ 8,041	
	30,000(3)							
Cash—branch	6,875(1)	5,000(1)					1,875	
Petty cash	2,500(2)						2,500	
Installment notes receivable		17,439(1)	$17,439(5)					
		27,780(1)	28,520(5)				740	
Debit balances with vendors			870(9)				870	
Advances to salesmen			1,005(7)				1,005	
Branch current	10,206(2)	6,875(1)	130(6)	$17,439(5)			3,812	
	22,392(3)			1,044(9)				
				3,558(10)				
Bank loans	25,000(2)			11,340(4)				$ 5,000
				18,660(4)				
Trucks	5,994(2)						5,994	
Taxes withheld		410(2)						410
Accumulated depreciation				333(6)				333
Accrued expenses				250(7)				648
				398(8)				
Partners drawings	3,775(2)						3,775	
M—investment		15,000(3)						15,000
N—investment		15,000(3)						15,000
Sales		10,700(1)		25,650(5)		$36,350		
Profit on branch		3,732(3)	174(9)					
			3,558(10)					
Purchases—h. o.	17,910(2)		11,340(4)		$29,250			
Purchases for branch		18,660(3)	18,660(4)					
Discount on notes	1,744(1)				4,522			
	2,778(1)							
Interest on bank loans	240(2)				240			
Interest and finance charges				2,870(5)		2,870		
Sales commissions	5,105(2)		250(7)	1,005(7)	4,350			
Warehouse and delivery expense	1,414(2)		203(6)		1,713			
			96(8)					
Miscellaneous selling expense	3,069(2)		212(8)		3,281			
General and administrative expense	3,553(2)		90(8)		3,643			
Inventory			7,440(5)	7,440(5)		7,440	7,440	
Loss						339	339	
	$198,952	$198,952	$89,987	$89,987	$46,999	$46,999	$36,391	$36,391

(See explanations following Part b.)

Part b

M & N—WORKSHEET FOR BRANCH
Three months ended October 31, 1952

	Trial Balance		Adjustments		Profit and Loss		Balance-Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash (deposits for home office)	$ 6,875			$ 6,875(4)				
Petty cash	2,500			463(3)			$ 2,037	
Installment notes receivable	17,439	$17,439						
Home office	18,483	22,392	$ 6,875(4)	130(1)				$ 9,870
				12,706(2)				
Remittances from home office		12,706	12,706(2)					
Taxes withheld		431						431
Accrued expenses				185(5)				185
Sales		22,550				$22,550		
Purchases	22,392	1,044			$21,348			
Interest and finance income		1,764				1,764		
Sales commissions	2,955		87(3)		3,042			
Warehouse and delivery expense	300		130(1)		805			
	375							
Miscellaneous selling expense	5,416		185(5)		5,601			
General and administrative expense	540		376(3)		1,967			
	1,051							
Inventory			5,112(6)	5,112(6)		5,112	5,112	
Loss						3,337	3,337	
	$78,326	$78,326	$25,471	$25,471	$32,763	$32,763	$10,486	$10,486

EXPLANATION OF NUMBERED ITEMS IN PARTS A, B OF SOLUTION 3

Part a

1. To record the cash receipts book summary.
2. To record the cash disbursement book summary.
3. To record the general journal summary.
4. To bring on to the books, the unrecorded purchases for the home office and branch and record the bank loans previously unrecorded.
5. To record the installment notes received, the interest and finance income and the inventory at end of the month based on data in item (2) of the problem.
6. To record depreciation as given in item (3) of problem.
7. To adjust sales commissions expense and set up the prepayment on the basis of information in item (4) of problem.
8. To record the accrued expenses based on item (5) of the problem.
9. To set up the receivable arising from the return of merchandise by the branch and credit the branch at billing price based on data in item (6) of the problem.
10. To transfer profit on branch into the branch current account so that in combining the statements there will be no duplication of profit items.

Part b

1. To pick up the depreciation on delivery equipment based on item (3) of problem.
2. To transfer the remittances to the home office account to facilitate combining statements.
3. To adjust the petty cash account to actual and record the unrecorded expenses previously paid.
4. To transfer the cash (deposits for home office) to home office account to facilitate combining statements.
5. To record the unpaid advertising expense.
6. To record the ending inventory at cost to the branch.

Part c

M & N—RECONCILIATION OF BRANCH AND HOME OFFICE

October 31, 1951

BALANCES PER H. O. BOOKS:			
Petty cash—branch		$ 2,500	
Remittances to branch		10,206	
Purchases for branch		22,392	
Total debits		$35,098	
Deposit by branch for home office	$6,875		
Profit on branch purchases	3,732		
Total credits		10,607	
Home office debit balance			$24,491
ADJUSTMENTS TO H. O. BOOKS:			
Notes received from branch		$17,439	
Merchandise returned to vendor by branch		870	
Total credits		$18,309	
Depreciation on truck used by branch		130	
Net credit adjustment			18,179
Corrected home office balance			$ 6,312
BALANCES PER BRANCH BOOKS:			
Notes sent to h. o.		$17,439	
Merchandise returned to vendor		1,044	
Deposits for h. o. account		6,875	
Total debits			$25,358
Petty cash from h. o.		$ 2,500	
Expenses paid by h. o.		10,206	
Purchases made by h. o.		22,392	
Total credits			35,098
Credit balance on branch books			$ 9,740
ADJUSTMENTS TO BRANCH BOOKS:			
Depreciation on truck used by branch			130
			$ 9,870
Profit on branch purchases		$ 3,732	
Less—Profit on goods returned to vendor by branch		174	3,558
Corrected branch balance			$ 6,312

Theory of Accounts

May 16, 1952; 1:30 to 5 p.m.

No. 1 (15 points)

Those accountants who argue for the all-inclusive income statement would not permit charges or credits to retained earnings except for capital adjustments, dividends and net profits. They would niclude in the income figures all other charges and credits which will affect retained earnings. They wish to have the income figures over the life of the business reflect all of its financial results. They minimize the significance of the income for any single year and emphasize the significance of the accurate portrayal of the long-run results. Therefore, they regard unusual or extraneous events to apply properly to income, since in the long run these events are not unusual or extraneous. They frequently point out the possibility of manipulation of income figures where charges and credits may be made to retained earnings without passing through the income account. They wish to prevent that evil.

Those accountants who do not approve of forcing all charges and credits through income would favor the exclusion from net income of material amounts which are extraneous or unusual. They attach considerable importance to the "normal net income" for a year. They urge that a figure of "net income for the year" is useful and is used by investors and others. They contend that such a figure, to be most useful, must not be distorted by the inclusion of material amounts for unusual items. They are not alarmed over the fact that the sum of a number of years' net income will not give the full results for those years. They would insist on adequate disclosure of the special items which are not included in net income, and rely on such disclosure to prevent incorrect interpretations by those individuals interested in the history of a particular business.

No. 2 (10 points)

After a period of rising prices, a business using the LIFO basis of valuing its inventories may find that there is a material difference between the carrying value of the inventory and its current market price. Such a difference may be so large as to result in the current assets being presented at an amount which is thought to be misleading. Those who advocate disclosure of market value argue that where the difference is material, it should be disclosed in order to avoid misleading the users of statements. They may also regard LIFO as somewhat an exception to usual practice and, therefore, would urge the disclosure to permit the reader of the statements to compare this business with other businesses using lower of cost or market, with cost computed on a FIFO basis.

Disclosure of current market value would facilitate comparison of operating results of companies using various methods since the user of the statements can readily adjust to eliminate the principal effect of LIFO if he desires to do so.

Those who argue against the need for disclosure do so in part on practical grounds. They point out that it would be difficult and expensive to determine current market value. In some instances they feel that a rough estimate would be the best that could be expected and that such an estimate might contain misleading errors. They regard LIFO as an accepted method and in no sense an exception to

usual procedures. They may point out that market may be above cost when FIFO is used, but that there is no obligation to disclose market in that case. They may suggest that if LIFO is consistently followed, the income statement more accurately measures revenue and cost than if FIFO were used. Therefore no adjustment need be made by the user of financial statements. Some of those who do not favor compulsory disclosure may regard normal inventories as permanent assets which must be held by the business and therefore do not require adjustment as a result of price level changes.

No. 3 (12 points)

The cost of spoiled units may be left in the regular accounts and be charged, along with other manufacturing costs, to inventories and ultimately to cost of goods sold or the cost may be segregated, excluded from inventories and charged as a separate cost of the period during which it was incurred.

The two circumstances under which different conclusions as to cost disposition are reached are where the spoilage is normal and recurring and where the spoilage is abnormal.

If the spoilage under consideration is normal for the kind of process in use, the cost of such spoiled units should be added to the cost of production of the good units. This may be done by leaving the total cost in the labor, material, and overhead accounts and dividing such total over the good production. Also it may be done by including the total amount of labor and material applicable to the spoiled units as a part of overhead to be applied to units produced. Whether spoilage is normal is not entirely determined by whether or not it might be prevented. It may be that in a particular business spoilage could be reduced or eliminated by the use of better materials or by the exercise of greater care in processing, but if the added cost of better material or more careful processing exceeds the loss from spoilage, the business may use such materials, or set up such a process as will result in some spoilage which will then be normal spoilage for that business.

If the spoilage under consideration is, in whole or in part, abnormal in view of the processes and materials used in production, the cost of such abnormal spoilage should not be permitted to increase costs of inventories but should be charged in full to the period in which it occurred. The most logical treatment is to segregate it from regular manufacturing costs and show it as a special item in the cost of goods manufactured and sold. As in other applications of accounting theory, the materiality of the amounts will be considering in arriving at a decision as to treatment in the accounts.

No. 4 (8 points)

In general, the cost of land and land improvements is not considered to be subject to depreciation, since the service and benefits are received for an indefinite period in the future.

In the case of improvements which will have to be replaced from time to time or which would be of no value to a subsequent purchaser who planned to use the land for a different purpose, the cost should be spread over the estimated useful life. Paving, curb and gutter, marking of parking space, and lighting installations

are examples of such costs. Drainage systems may have a limited life, in which case the cost would be subject to depreciation.

Sometimes, where an improvement can be kept in usable condition indefinitely by partial replacement or ordinary maintenance, the depreciation charge may be omitted. Paving and painting of parking spaces are examples of this possibility, although there would still be the probability of such assets not being of value to a subsequent purchaser.

No. 5 (15 points)

a. The installment basis makes the receipt of cash the point of revenue recognition instead of using the sale as the event which permits the recognition of revenue. Principal arguments for the use of the installment method are the uncertainty of ultimate collection of the full amount and the cost of carrying and collecting the accounts. The principal argument for taking up the revenue at the time of sale is that the amount is definitely ascertainable at that time. The major event is the sale. Uncertainty of full collection can be provided for by the usual method of setting up a provision for loss on bad accounts. Neither of the methods seems to be ideal. Probably the most satisfactory method would take up the revenue at time of sale less provisions for future expenses involved on the accounts and for losses from the accounts. However, there are practical difficulties in such a method which make its use uncommon.

b. The installment basis of reporting income provides for computing the gross profit on the sales of a year and taking that gross profit into income of that and subsequent years in proportion to the amount that cash collected in each year is of the total to be collected.

c. As a result of using one method for tax returns and another method for computing profit on its books, the Jones Co. will be reporting income in its statements but not paying or including the tax on such income until the year in which the cash is collected. Also, it will be including in any year, except the first one, taxes which are applicable to income taken up in prior years. There is a lag in charging to the income account the taxes on reported income. This will result in a continuing understatement of tax liability as compared with the taxes finally due on the income recorded, if operations continue to be profitable. If tax rates were constant and the amounts of gross profit and collections for each year were constant, the income for any year except the first and last years of operation would be unaffected. However, there is small probability of the three factors remaining constant, with the result that revenue and cost will not be matched in so far as taxes are a part of cost.

The committee on accounting procedure of the American Institute took note of a similar situation in Bulletin No. 23. They conclude that income taxes are an expense which should be allocated where necessary and feasible. The income statement should contain the tax which is applicable to the income shown in the statement if it is to be of the greatest usefulness as a measure of earnings. In situations where material and unusual differences exist between the amount of income on which taxes are based and the amount of income in the income statement, it is recommended that the tax be allocated, if feasible, in such a manner as to cause

the income statement to reflect the taxes which would be payable on the income in the statement.

No. 6 (10 points)

The operating statements would differ because the interest expense incurred by M would not be included in manufacturing costs nor in cost of goods sold, but would be charged below operating profit, whereas rent paid by N would be included in manufacturing expense (except to the extent that the plant may be used for selling and administrative functions). If the rental paid by N is reasonably equal to interest plus depreciation, taxes, insurance, and other costs of plant ownership, the total costs might be about the same. However, in the detailed statements these costs would be separately identified for M but not for N since only the annual rental charge would be listed.

To obtain comparable manufacturing costs, all costs of plant ownership could be taken out of the overhead costs of M and the rental cost out of the overhead of N. However, comparability obtained in that manner would fail to reflect the advantage or disadvantage of plant ownership as compared to leasing plant and equipment. To retain that comparison, it would be necessary to include bond interest paid by M, and possibly an interest amount on the $140,500 of plant investment not covered by bonds, as a manufacturing overhead cost for M Company or to remove the cost of depreciation, taxes, insurance, etc., from the accounts of M and substitute an amount equal to the fair rental value of its plant and equipment.

No. 7 (15 points)

a. The principal balance-sheet items which might not be expressed in current dollars are inventories; fixed assets and intangibles; and capital stock and surplus.

Comments: Under average or FIFO methods of identifying inventory costs, earlier dollars are charged to cost of goods sold and more current dollars remain in inventory. The higher the inventory turnover, the more current are the inventory dollars. Under the LIFO method, however, current costs are charged to income and older dollars are used in valuing inventory. This is also true of the base stock method.

Fixed assets and intangibles are normally stated in terms of dollars of year of acquisition.

Liabilities are normally shown in terms of current dollars.

Capital stock and paid-in surplus are stated in terms of dollars of the year the stock was issued. Earned surplus is a mixture of dollars. If all assets are stated in current dollars the total net worth will be stated in current dollars, although the individual net worth items will not. For example, if stock is issued for property and some years later an appraisal increase is recorded, the credit is to appraisal surplus rather than to capital stock.

b. In the income statement, costs of goods sold and depreciation are the principal items which might not be expressed in current dollars. LIFO and base stock inventory methods tend to state cost of goods sold in current dollars. If an appraisal has been recorded, depreciation is based on the appraisal value which would be more current than the acquisition cost.

c. In the statement of funds, most if not all items are expressed in current dollars. The funds applied are stated in current dollars. Property is purchased, debt is retired, and dividends are paid in current dollars.

Funds received are usually stated in current dollars, such as funds received from the issuance of stocks, the issuance of bonds and the sale of fixed assets.

Comments: In determining the funds provided by operations the income statement is adjusted for expenses which did not require current expenditures. Thus depreciation is eliminated. If either LIFO or base stock inventory methods are used, the funds provided from operations are stated entirely in current dollars. If either FIFO or average methods are used, the funds provided from operations are in part stated in non-current dollars.

No. 8 (15 points)

a. The management of the financial affairs of a governmental unit must continually take into consideration the limitations imposed on the unit in utilizing its resources. These limitations arise from a variety of sources which may impose restrictions on the manner of making expenditures and the amount of expenditures for various purposes. Separate funds are created to assist in determining that money is applied only for designated purposes and in accordance with the restrictions and limitations imposed on those responsible for making expenditures.

b. The following funds or type of funds are proposed by the National Committee on Municipal Accounting as being adequate for the ordinary municipality:

1. General fund—This fund includes all revenues and other receipts which are available for general purposes and, therefore, are not restricted to some specified use. The general fund consists of cash, taxes receivable, estimated revenues, advances to other funds, various current liabilities, reserves for encumbrances, appropriations and surplus.

2. Special revenue funds—A municipality may have several funds of this type. Such funds include amounts of revenues which are expendable only for specified purposes. Composition of the fund is similar to the general fund.

3. Working capital funds—Working capital funds are created to finance and account for service operations for other units of the government. These funds will ordinarily consist of cash, due from other funds, inventories, and fixed assets which are offset by current liabilities and capital or advances.

4. Utility funds—Such funds are created to account for the operation of municipally owned and operated utilities. Ordinarily these are presumed to be self-supporting activities. These funds are comparable to a privately owned utility except for the substitution of government's contribution for capital stock.

5. Bond funds—These funds are created to account for the disposition of the proceeds of bond issues which are not related to special assessments or to utilities. Assets consist of cash and bonds authorized. Current payables, reserve for encumbrances, and reserve for authorized expenditures offset the assets.

6. Sinking funds—These funds are set up to account for the accumulation of resources intended for use in retiring bonds. Cash, investments and taxes receivable are found as assets in such funds. Surplus and reserve for retirement of bonds are credits.

7. Special Assessment funds—These funds are set up to provide for the financing of improvements to be paid from the proceeds of levies against the individuals or properties benefited. Cash, assessments receivable, and possibly interest receivable are the usual assets. Contracts payable, bonds payable, and reserve for encumbrances are the usual credits.

8. Trust or agency funds—These funds may either be expendable or nonexpendable. However, the essential feature is that the municipality is serving as a trustee or agent in relation to the fund. The fund assets are likely to consist of cash and investments. The total is offset by a fund balance.

No. 9 (15 points)

General accounting theory assumes that each company is a separate and independent entity. It presumes that in the acquisition of assets, either individually or in groups, the cost to the purchasing company is the most appropriate measure of value unless the transaction was not made at "arm's length." Therefore, in general accounting theory, assets acquired by one company from another will be recorded at the amount paid by the purchaser. This purchase price may be assigned to individual assets by several different methods, one of which might be based on the carrying value on the seller's books. Also appraisals are sometimes used to assign the purchase price to individual assets. In some instances, the amounts fairly assignable to tangible assets do not equal the purchase price and the difference is recorded as "good-will" or under some similar description.

This general treatment differs from the regulatory rule which does not permit a purchasing company to assign the purchase price to the tangible assets if it exceeds the carrying value on the books of the seller. While the amount in the plant adjustment account in some instances might correspond to the amount which would be classified as "goodwill" under general accounting, the reasons for so treating it are different. "Goodwill" is recorded only when a portion of cost cannot be assigned to specific assets, whereas the amount to go in the plant adjustment account is not based on inability to assign the cost to specific assets.

From the standpoint of using accounting records as a factor in setting service rates, we find the principal argument advanced for the required classification to proceed thus:

The business is a monopoly and, presumably as such, could collect exorbitant rates for its essential services. The value of the property used in the business is one factor which should be considered in setting fair rates which allow a reasonable return to the owners of the business.

If a property is sold for more than its cost (less amortization based on life and use of the property) such price is based on capitalization of its earnings. However, the allowable rates should not produce more earnings than are necessary to attract adequate capital to the industry. Rates should not provide a return which will induce a purchaser to pay more than carrying value of the assets, and any such excess which is paid should not be considered in the base used for setting present and future rates.

Examination in Auditing

May 15, 1952, 9 a.m. to 12:30 p.m.

No. 1 (10 points)

a. The following wording of a short-form report, recommended by the committee on auditing procedure of the American Institute of Accountants in 1948, is typical:

"We have examined the balance-sheet of X Company as of December 31, 19—, and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

"In our opinion, the accompanying balance-sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19—, 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."

b. We have examined the balance-sheet of X Company as of December 31, 19—, and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards except that no confirmations were obtained of accounts receivable from foreign customers; however, we satisfied ourselves by other means that these accounts were fairly stated.

This particular qualification as to scope of the examination would not generally necessitate a change in the "opinion" paragraph. However, the qualification might be of such a nature as to prohibit the expression of an opinion as to the statements. In that case, the auditor would state his reason for not expressing an opinion.

No. 2 (15 points)

Where there are two or more possible sources of information, in general any source may be used in preparing the worksheet and the other(s) used in checking it.

a. *Sources of information:*

1. Last year's working papers for those on hand at first of year. Brokers' advices for those purchased and sold within the year. Client's list for those on hand at end of year.

2, 3. Last year's working papers.

4-6. (Purchases only) Brokers' advices and invoices.

4-7. (Sales only) Carrying value (or current year's purchase price) will be obtained from column 3 (or column 6) and will be entered in column 6. Entries for column 7 will be computed from column 6 and brokers' advices or cash receipts records. Information for columns 4 and 5 will be obtained from brokers' advices or cash receipts records.

8, 9. Client's list or computation from columns 2 and 3, and 4, 5 and 6.

10. Market quotations.

11. Last year's working papers or general ledger.

12. Brokers' advices and invoices.

13. Computation for interest and published dividend records for dividends.
14. Computation or cash receipts book.
15. Computation using columns 1, 2, 4 and 5. An alternative computation may be made using columns 11, 12, 13 and 14.

b. *Method of verification:*

General—Columns 3, 6 and 9 should cross-add. Also columns 11 to 15 should be cross-added.

1. Inspection or confirmation of those owned at end of year. Brokers' confirmations of those not on hand.

2, 3. Tie to last year's statement.

4-6. (Purchases only) Columns 6 and 12 must be verified together. Check to cash disbursements and tie to analysis of general ledger accounts. In some instances, tests of prices may be made to quoted daily market prices.

4-7. (Sales only) Columns 6, 7 and part of 14 must be verified together. Check entries to cash receipts or brokers' advices and tie to analysis of general ledger accounts. In some instances, tests of prices may be made to quoted daily market prices.

8, 9. Physical inspection or confirmation. Tie to general ledger account. Cross-check schedule.

10. Check to an additional source of quotations or confirm with broker for inactive securities.

11. Tie to general ledger or to last year's statements.

12. Verify along with verification of purchases. Compute using data in columns 4 and 5. Check to cash disbursements and analysis of general ledger account.

13. If accruals were recorded, tie in column total with balance in general ledger account. If accruals were not recorded by client, reconcile with general ledger balance using the amount of year-end accrual shown by column 15.

14. Tie in with analysis of general ledger account for investment income if no accruals were recorded or if year-end accruals only were recorded. If monthly accruals were recorded, an analysis of the account for interest and dividends accrued or receivable will be necessary.

15. Use alternate method of computation. If accruals have been recorded, tie in with general ledger account balance.

No. 3 (15 points)

The following records, reports, and data might be found:

1. A personnel form for each employee showing his name, address, social security number, date of hiring, job assignment, wage rate, and other information.
2. Time cards or reports for each employee.
3. Documents and forms supporting withholding of wages for social security taxes, bonds, hospitalization, Federal and state income taxes, pensions, etc.
4. Payroll disbursement records, including receipts or cancelled checks.
5. Copies of payroll tax returns.
6. Compensation insurance policies.
7. Labor distribution by jobs.

8. Copies of union contracts, employment contracts with officers or key employees, copies of pension plans, minutes (authorization of officers' salaries), partnership agreement, or similar documents.

The form and records would be used in the following ways:

1. Calculating or checking accruals of payroll, taxes, and various amounts withheld from the salaries and wages.
2. Investigating the possible existence of contingent liabilities as a result of failure to comply with tax or labor laws.
3. Testing inventories of work in process and finished goods, if any.
4. Reviewing payroll for fraud and appraisal of internal control.
5. Testing the correctness of the classification of payroll cost in the various expense accounts.

No. 4 (18 points)

In connection with fixed assets, the major procedures by which the auditor will satisfy himself that all assets are recorded, and that the amounts which the accounting records show are the amounts which the accounting records should show are:

1. Review the accounting procedures of the company and the system of internal control to determine their adequacy. Sound procedures and an effective system of internal control give assurance that the amounts which the accounting records show are the amounts which the accounting records should show.
2. Vouch additions to fixed asset accounts to determine if expenditures were capitalized which should have been charged to revenue. This procedure is necessary to establish that the value of an asset is not being improperly increased through additions.
3. Analyze repair expense and other expense accounts to determine if expenditures were charged to revenue which should have been capitalized. This is to establish that assets owned are not expensed and that asset additions are not expensed.
4. Schedule and analyze credits to fixed asset accounts to determine the reason for, authority for, and the propriety of the accounting entry for fixed asset retirements. This test is to determine that useful assets have not been written off and that correct amounts have been written off when assets are retired.
5. Review the basis used in recording additions and make tests to determine that correct accounting principles are followed in valuing assets acquired through purchase, exchange, or construction. While this procedure is connected with determining ownership, one of its prinipal purposes is to assist the auditor in determining that the basis of valuation is acceptable.
6. Review retirements in relation to additions. This may serve to indicate unrecorded replacements.
7. Inquire and check as to changes in products and production methods. Such changes usually involve retirement of some assets and addition of other assets. Physical inspection of the plant may be helpful in determining that all assets are recorded.

8. Review authorization for plant additions. The authorization should be tied in with plant additions and construction in process as an indication that the assets have been recorded. Since authorization may contain an estimate of the cost of additions, they also afford some evidence as to the correctness of the amount at which the additions are recorded.

9. Inspection of construction contracts, architects' certificates, and similar documents afford some evidence as to the amounts at which the assets are on the books. A check from such records to the asset account helps to establish that the assets which are owned are in fact on the books.

10. The general audit procedure of cross-checking amounts from one account into another account is helpful as to both features of the assets.

No. 5 (15 points)

Among the inquiries an auditor might make of officers and employees are the following:

1. The collectibility of receivables. An auditor commonly asks the credit manager for his opinion on the collectibility of receivables and for the basis of his opinion. The purpose of the inquiry is to obtain evidence as to the adequacy of the reserve for doubtful accounts.

2. The existence of contingent liabilities. An auditor commonly asks the president or executive officer in charge about the existence of and extent of contingent liabilities. The purpose is to obtain information which is not reflected in the books of account but which requires disclosure in the financial statements.

3. Changes in operations. During his preliminary tour of the plant an auditor commonly asks the works manager, superintendent, and department foreman about changes in operations. The purpose is to obtain information about purchases and retirements of fixed assets and other changes to be used in verifying fixed assets, analyzing depreciation reserves, auditing payrolls, reviewing cost records, costing inventories, etc.

4. Depreciation and depletion. An auditor commonly asks the plant or mine engineer for the basis of his estimate of depreciation and depletion. The purpose is to determine if the estimate is reasonable and has given adequate weight to such factors as obsolescence as well as to physical condition. Such inquiry may be coupled with inquiry as to the general physical condition and use of the fixed assets.

5. The company's legal department is frequently asked questions concerning title to assets and concerning litigation. The purpose is to determine the status of title and to determine the existence and amount of liabilities or contingent liabilities.

6. Inquiries may be directed to the company's official in charge of insurance. The purposes are to determine the adequacy and basis of coverage and to obtain information as to policy values, cancellations, etc.

7. Inquiries are frequently directed to the corporation's secretary. The inquiries may concern a variety of things depending largely on the organization

structure of the company. They are likely to concern various actions taken by the stockholders or board of directors. In such cases, the auditor is seeking clarification or elaboration of the minutes or other records.

8. An auditor may ask for explanations of matters which are not entirely clear from the records. The purpose is to determine the nature of the underlying transaction in order to decide whether the records fairly present the situation and in order to decide what evidence to examine in support of th erecords. The inquiry is often directed to the employee who made the record and subsequently to those who authorized the transaction if the explanation is not completely satisfactory.

9. An auditor makes an investigation of events occurring subsequent to the balance-sheet date. Inquiries directed to officers are one means of learning about the significant events which have occurred.

No. 6 (12 points)

a. A second reconciliation is frequently made after the balance-sheet date. The second reconciliation helps to establish the validity of the outstanding checks at the year-end since most of them will clear before the second reconciliation. It also helps to establish that the list of outstanding checks at the balance-sheet date is complete. For example, matching the cancelled checks which were returned with the cut-off bank statement against the cash book entries will disclose "kiting." The second reconciliation will also support any deposit-in-transit at the balance-sheet date and will disclose uncollectible checks which were included in deposits of the period under audit.

b. Collections subsequent to the balance-sheet date are often scheduled against the accounts receivable which were open at the balance-sheet date. This supports the genuineness of the accounts receivable and is a guide in estimating their collectibility. Also sales returns and allowances subsequent to the balance-sheet date are reviewed for indications of shipments which may have been made without customers' orders, for shipments of defective goods and for fictitious sales. Existence of these conditions would require an adjustment of receivables at balance-sheet date.

c. Purchases, purchase returns and allowances, sales and sales returns and allowances subsequent to the balance-sheet date are reviewed in connection with the inventory cut-off. The purpose from the inventory standpoint is to determine that the inventory includes only items which have been recorded as purchases and that all goods which are owned have been correctly recorded. Also receiving and shipping records subsequent to the balance-sheet date are used in checking the inventory cut-off. Where an improper cut-off has been made, adjustment of the inventory, receivables or payables must be made as appropriate.

d. Entries recorded in the voucher register or cash disbursements book subsequent to balance-sheet date are customarily vouched to determine if there are additional liabilities which should have been recorded as of the balance-sheet date.

No. 7 (15 points)

a. The objectives of internal control are to protect the resources of an enterprise and to assure that the financial records properly reflect business transactions and the results of those transactions. A system of budgetary control would help to assure that expenditures were made for approved purposes only and that unapproved expenditures would not be made. A system of budgetary control also gives a predetermined estimate of the accounting results of business activities and analysis of variances would normally be undertaken. This analysis would show how actual business activities varied from the anticipated activities or would point to any major errors which existed in the accounting records.

b. Internal control involves not only control of cash, but also control of other assets. Perhaps no other asset is more difficult to control nor more susceptible to loss or misappropriation than postage stamps. A postage meter machine affords the means of real control over postage. The meter imprint should be valid only on envelopes which bear the business return address. A day-by-day record of postage use is maintained, and a clear accountability for postage may be established. Centralized control under lock and key is easily established.

c. Monthly statements of account serve the same purposes as an auditor's confirmation requests. This is especially true if the statements are checked and mailed and complaints are handled by someone who is independent of the accounts receivable department. Fictitious accounts might be uncovered, and differences between the company's records and those of its customers would be brought to light for investigation, correction, or adjustment.

d. A purely arithmetical reconciliation will give only an arithmetical check on accuracy. Non-arithmetical procedures greatly extend the usefulness of the reconciliation as an element of internal control. Examination of endorsements is an important non-arithmetical procedure to be followed when reconciling bank accounts.

It is usually expected that a cancelled check will serve as a receipt and no other receipt is usually obtained. If the endorsement is irregular, the cancelled check is not a satisfactory receipt.

A second endorsement on a check suggests the possibility of fraud. This is particularly true if the second endorsement is that of an employee of the company.

Most companies use a rubber stamp to endorse checks. Such an endorsement indicates that the check was deposited, not cashed. A handwritten endorsement on a check to a corporation should be questioned, as should any other unusual endorsements.

e. In instances in which an employee desires to defraud the company, he is faced with the problem of getting usable assets. Various schemes which might be worked out by an employee would result in the receipt of a check made out to the company. If the employee is unable to cash such check, he must obtain access to cash in some other manner. The cashier is also handicapped in any attempts to carry on lapping if he cannot cash checks.

Commercial Law

May 16, 1952, 9 a.m. to 12:30 p.m.

Group I

No. 1 (10 points)

a. Yes. Lack or failure of consideration is a personal defense which is not effective as to a holder in due course. (Uniform Negotiable Instruments Act, Section 28, 57.)

b. You must properly present the instrument to the maker at maturity and, if (and when) he refuses to pay, send proper notice of dishonor to the payee. He has indorsed without qualification and is liable as a general indorser. (Uniform Negotiable Instruments Act, Section 66.)

c. Yes. Lack of delivery, or delivery on a condition, is a personal defense which is not effective as to a holder in due course. (Uniform Negotiable Instruments Act, Section 16.)

d. Yes, in both cases. Although the bank is not a holder in due course, having taken the paper after maturity, you were a holder in due course. Therefore, your bank derives its title from a holder in due course and has all rights which you possessed. The defenses in case (a) and case (c) are not good against either you or your bank. (Uniform Negotiable Instruments Act, Section 58.)

No. 2 (10 points)

a. 1. Yes. In the absence of a contract to that effect, a surety is not entitled to notice of default. Mere indulgence by C does not release S. (Restatement of Security Section 136.)

2. No. A release of the principal debtor by the creditor automatically releases the surety because such release robs the surety of his recourse to the principal debtor for indemnity. If the release was given with the reservation of rights against the surety, the latter would remain liable. The same would also be true if the surety were adequately protected by collateral in his possession. (Restatement of Security Section 122.)

b. 1. S may obtain $6,000 from X. Co-guarantors share any loss in proportion to their maximum liabilities. Because of this rule, S should be able to recover $6,000 from X, unless X had been compelled previously to pay something because of his guaranty. The total losses by them should be shared at the rate of one-third by S and two-thirds by X. (Restatement of Security Sections 146, 149.)

2. The sharing of the net loss would remain on the ratio of one to two, but S would be obligated to share the collateral with his co-surety on that basis, unless X had in some manner, at the time he became a guarantor, approved the security as protection for S alone. There is an implied understanding that co-guarantors accept the same risk unless they have a clear understanding to the contrary. (Restatement of Security Section 154(3).)

No. 3 (10 points)

a. *Sale on trial.* When there is a delivery to the buyer "on approval" or "on trial" the property and title pass to the buyer: (1) when he signifies his approval or acceptance to the seller, or (2) in the absence of either acceptance or rejection

by the buyer, when the time fixed for the return of the goods (or a reasonable time, when no return date is fixed) has expired.

Sale or return. When there is a delivery to the buyer "on sale or return," meaning that there is a present sale but that the buyer may return the goods instead of paying the price, the property and title pass to buyer upon delivery, but he may revest the property and title in the seller by returning the goods to the seller within the time fixed in the contract (or within a reasonable time, when no return date is fixed). (Uniform Sales Act, Section 19, Rule 3.)

b. The buyer. The risk of loss follows the title, and where the seller has *completed* his side of the contract by delivering the goods to a carrier, the title passes to the buyer. (Uniform Sales Act, Section 22; Section 19, Rule 4 (2).)

c. The indorser warrants that: (1) the document is genuine; (2) the indorser has a legal right to negotiate the document; (3) the indorser has knowledge of no fact that would impair the validity or worth of the document; (4) he has a right to transfer the title to the goods, and that the goods are merchantable or fit for a particular purpose, whenever such warranties would have been implied if the contract of the parties had been to transfer without a document of title the goods represented thereby. (Uniform Sales Act, Section 36(a, b, c, d).)

d. Where the seller delivers to the buyer a quantity of goods larger than he contracted to sell, the buyer may accept the goods included in the contract and reject the rest, or he may reject the whole. If the buyer accepts the whole of the goods so delivered, he must pay for them at the contract rate. (Uniform Sales Act, Section 44(2).)

No. 4 (10 points)

a. An unincorporated club or other voluntary association is not a legal entity in the absence of a statute making it such. Thus, in a jurisdiction where such an organization is not a legal entity there can be no agent for the club or association, as such, because it has no legal existence. However, the members of such an organization can appoint an agent and be personally liable as principals. Whether one acting as the agent for such an organization is the agent of all members or only certain of the members would depend upon the agreement and the manifestations of the members. (Restatement of Agency, Sections 20 and 21; 4 American Jurisprudence, Associations and Clubs, Sections 40 and 41.)

b. 1. Contract action for breach of implied warranty of authority. Generally a person who purports to make a contract, conveyance, or representation on behalf of a principal whom he has no power to bind thereby, becomes subject to liability to the third party upon an implied warranty of authority, unless he has manifested that he does not make such warranty or the third party knows that the person is not so authorized. (Restatement of Agency, Section 329.)

2. Tort action for fraud. A person who willfully misrepresents to a third person that he has authority to make a contract, conveyance, or representation on behalf of a principal whom he has no power to bind thereby, becomes subject to liability to the third person in an action of tort for loss caused by reliance upon such misrepresentation. (Restatement of Agency, Section 330.)

3. If the alleged agent, without authority, executed a negotiable instrument in the name of his principal, the third party may hold the alleged agent personally liable on the instrument. Even though the instrument names the purported principal and shows the alleged agency relationship, the alleged agent is liable on the instrument if in fact he had no power to bind the person represented to be the principal. (Restatement of Agency, Section 324; Uniform Negotiable Instruments Act, Section 20.)

c. A sales agent who has assumed a duty to pay his principal what the purchaser fails to pay, whether this is due to the insolvency of the purchaser or to other causes. (Restatement of Agency, Section 424 (d).)

No. 5 (10 points)

a. A promoter is one who brings about the incorporation, organization, and financing of an incorporated enterprise. (1 Fletcher, Cyclopedia Corporations, Section 189.)

b. No, unless the corporation expressly adopts the contract or does so impliedly by accepting the benefit of the contract. (1 Fletcher, Cyclopedia Corporations, Sections 205-211.)

c. Quorum: That number or proportion of persons, shares represented, or officers who may lawfully transact the business of a meeting called for that purpose. In the case of a meeting of stockholders, what constitutes a quorum to transact business is usually regulated by statute, charter or by-laws. Generally such express provisions require that a majority or other specified amount of the outstanding shares of stock (rather than the number of shareholders) shall be represented in order to have a quorum. But in the case of a meeting of the board of directors, a majority or other specified number of the individual members must be present to constitute a quorum. (5 Fletcher, Cyclopedia Corporations, Section 2013.)

d. No. The authority of the directors must be exercised as a body and not individually. Action by one or all independently will not bind the corporation. (2 Fletcher, Cyclopedia Corporations, Section 392.)

No. 6 (10 points)

a. No. This is a contract or bargain to restrain trade and prevent competition. Such bargains are illegal and unenforceable if unreasonable. In this case it is unreasonable because it is based on a promise to refrain from competition and is not ancillary either to a contract for the sale of a business or to a contract of employment. (Restatement of Contracts, Sections 514 and 515.)

b. No. This is a restraint upon trade and competition, but it is a reasonable restriction designed to protect the value of the property or business sold and, provided B is not engaged in a plan to create a monopoly, is legal and enforceable. (Restatement of Contracts, Section 516.)

c. No. A covenant unlimited as to time and area, or one in which the time and area is so great as obviously to go beyond the protection needed by the purchaser is in restraint of trade and unenforceable. (Restatement of Contracts, Sections 514, 515.)

No. 7 (10 points)

a. A negotiable instrument, properly in the hands of a holder in due course, is free of many defenses that could be interposed by prior parties to avoid payment of the instrument. A non-negotiable instrument is subject, in the hands of any holder, to all defenses which have accumulated against paying the instrument. (Uniform Negotiable Instruments Act, Section 57; 7 American Jurisprudence, Bills and Notes, Section 17.)

b. An instrument, to be negotiable, must:

1. Be in writing and signed by the maker or drawer.
2. Contain an unconditional promise or order to pay a sum certain in money.
3. Be payable on demand or at a fixed or determinable future time.
4. Be payable to order or bearer.
5. Where the instrument is addressed to a drawee, he must be named or otherwise indicated therein with reasonable certainty.

(Uniform Negotiable Instruments Act, Section 1.)

c. 1, 2, and 4 are each types of bearer paper. Bearer paper is negotiated by delivery without the need of indorsement. 3 is an order instrument and the indorsement of the payee plus delivery is necessary for negotiation. (Uniform Negotiable Instruments Act, Sections 8, 9, and 30.)

d. 1. Blank—specifies no indorsee, the instrument becomes payable to bearer and may be further negotiated by delivery. (Uniform Negotiable Instruments Act, Section 33.)

2. Special—specifies the person to whom or to whose order, the paper is payable; and the indorsement of such indorsee is necessary to the further negotiation of the paper. (Uniform Negotiable Insruments Act, Section 34.)

3. Restrictive—(a) Prohibits further negotiation of the paper, or (b) makes the indorsee agent of indorser, or (c) vests title in indorsee in trust or for the use of some other person.

(Uniform Negotiable Instruments Act, Sections 36, 37.)

4. Qualified—negotiates the paper and does not impair its further negotiability, but makes the indorser a mere assignor of title to the paper. Thus the indorser is free of his liability as a general indorser but remains chargeable on his warranty as a seller. (Uniform Negotiable Instruments Act, Sections 38 and 65.)

5. Conditional—transfers the paper subject to an expressed condition. The maker may disregard the condition and pay the holder at maturity. The holder is subject to the condition, however, and keeps the money paid on the paper only if the condition has been fulfilled. (Uniform Negotiable Instruments Act, Section 39.)

No. 8 (10 points)

a. 1. A valued policy fixes a specific value on the property insured. (29 American Jurisprudence, Insurance, Sections 1188 and 1222.)

2. An open policy does not fix any specific value on the property insured, but it establishes a specific maximum liability of the insurer for loss or damage to such property. (29 American Jurisprudence, Insurance, Section 217.)

b. A binder is a written memorandum of an oral, temporary contract of insurance, issued by the insurer to evidence such contract pending consideration and issuance of a formal policy. (29 American Jurisprudence, Insurance, Section 143.)

c. Insurance is a legal contract whereby the insurer indemnifies the insured against an existing risk of loss. The insured must have an insurable interest. A wager is an illegal agreement whereby the parties seek profit through chance, no risk of loss existing prior to such agreement. (29 American Jurisprudence, Insurance, Section 318 and 319.)

No. 9 (10 points)

a. A common carrier of goods holds itself out to serve the public generally to the limit of its facilities in the transport of goods for hire in which it is engaged. A private carrier of goods does not so hold itself out and may serve whom it pleases. (13 Corpus Juris Secundum, Carriers, Sections 3 and 4.)

b. A private carrier of goods is liable only for negligence which causes damage or loss to goods in transit. A common carrier of goods is absolutely liable as an insurer for damage or loss to goods in transit without any negligence on its part, except when such damage or loss is caused by one or more of the following:

1. An act of God.
2. An act of a public enemy.
3. An act of the shipper.
4. The inherent nature of the goods.
5. An act or mandate of public authority. (13 Corpus Juris Secundum, Carriers, Sections 71, 74, 75; 9 American Jurisprudence, Carriers, Sections 723 and 724.)

c. A common carrier of goods may justifiably refuse to accept goods for transportation when:

1. It is not equipped to transport such goods.
2. The goods are not properly prepared for transportation.
3. Transportation of such goods is illegal.
4. The goods are inherently and unduly dangerous to other property or to the public.
5. The goods are injurious to public health, peace, or morals.
6. The proferred goods are perishable and it has all the goods it can transport for so long that the proferred goods may perish before being transported.
7. Reasonable regulations of the common carrier regarding the time, etc., of presenting goods have not been complied with. (13 Corpus Juris Secundum, Carriers, Section 28); 9, American Jurisprudence, Carriers, Sections 300 and 302.)

a. The following are ways in which a lease may be terminated:

1. By expiration of the lease. When the time for which it is to run expires, the lease is automatically terminated unless it contains provisions to the contrary. (1 Tiffany, Real Property, Section 147.)
2. By forfeiture. If the tenant violates any of his express obligations under the contract of lease, the lease will be terminated. (1 Tiffany, Real Property, Section 152.)

3. By eviction by paramount owner. If lessee is evicted or excluded from premises by a person having title superior to the lessor, the lease is terminated. (1 Tiffany, Real Property, Section 146.)

4. By condemnation. Where the right of eminent domain has been exercised to condemn for public use, the tenant is relieved to the extent that the premises are condemned. (3 Tiffany, Real Property, Section 904.)

5. By destruction or substantial injury to the premises. Where the premises consist merely of a building or portion of a building, destruction of the leased premises terminates the lease since there is no longer any subject matter on which the lease can operate. But where the premises include land, in the absence of statutory provisions or express clauses in the lease, it is generally held that destruction or substantial injury to the buildings does not terminate the lease. (1 Tiffany, Real Property, Section 154.)

6. By merger. When the lessee acquires the whole estate, thus in effect becoming his own tenant, the lease is terminated. (1 Tiffany, Real Property, Section 151.)

7. By surrender or mutual agreement. Where the landlord and the tenant mutually agree to terminate the lease and the landlord takes possession of the premises, the tenant is relieved of any further liability on the lease. (1 Tiffany, Real Property, Section 150.)

8. By operation of law, for example, when a tenant at will dies. (1 Tiffany, Real Property, Section 163.)

b. If a lessee transfers to another the entire interest which he holds under a lease, reserving no interest to himself, he has thereby made an assignment of the lease. If, however, a lessee transfers to another less than the entire interest which he holds under a lease, thus reserving some interest in the lease to himself, he has thereby made a sublease. (1 Tiffany, Real Property, Section 123.)

No. 11 (10 points)

1. False. (Scott on Trusts, 1939, Vol. 1, Section 52); (54 American Jurisprudence, Trusts, Section 44.)
2. False. (Scott on Trusts, 1939, Vol. 1, Section 53); (54 American Jurisprudence, Trusts, Section 45.)
3. True. (Restatement, Trusts, Sections 28 and 29); (54 American Jurisprudence, Trusts, Section 41.)
4. False. (Restatement, Trusts, Section 100); (54 American Jurisprudence, Trusts, Section 116.)
5. False. (Restatement, Trusts, Sections 18 and 19); (Scott on Trusts, Section 18.)
6. True. (Restatement, Trusts, Sections 35 and 36); (Scott on Trusts, Sections 35 and 36.)
7. False. (Restatement, Trusts, Section 40 Comment d); (Scott on Trusts, Section 406.)
8. False. (Restatement, Trusts, Section 53 Comment a); (54 American Jurisprudence, Trusts, Section 5.)

9. True. A general rule to this effect has grown up in connection with savings bank accounts. (Restatement, Trusts, Section 58, Comment b); (Scott on Trusts, Section 58.4.)

10. True. (Restatement, Trusts, Section 75); (54 American Jurisprudence, Trusts, Section 32.)

No. 12 (10 points)

1. (b) Personal property. (2 Tiffany, Real Property, Section 617.)
2. (b) Personal property. (1 Tiffany, Real Property, Section 7.)
3. (b) Personal property. (5 Tiffany, Real Property, Section 1412.)
4. (b) Personal property. (2 Tiffany, Real Property, Section 595.)
5. (b) Personal property. (1 Tiffany, Real Property, Sections 9, 10.)
6. (a) Real property. (22 American Jurisprudence, Fences, Section 10; 2 Tiffany, Real Property, Sections 606 through 610.)
7. (a) Real property. (2 Tiffany, Real Property, Section 587.)
8. (b) Personal property. (1 Tiffany, Real Property, Sections 4 through 10.)
9. (a) Real property. (22 American Jurisprudence, Fixtures, Sections 2 through 12.)
10. (a) Real property. (2 Tiffany, Real Property, Section 590.)

Examination Answers, November, 1952

Accounting Practice—Part I

November 5, 1952, 1:30 to 6 p.m.

No. 1 (20 points) (Required)

(AMOUNTS AND PRINCIPAL ITEMS)

Page	*Sch.*	*Line*	*Enter*					
1	1	A						1
		D						1
		E						2
1	2		Advance Mfg. Co.				$5,620.	$30,000.
			Allowances—$3,000, less expenses of $1,700 paid for travel, etc.					1,300.
			City of Springdale					1,000.
								$32,300.
1	3							$11,961.90
1	4							44,261.90
1	6	A						5,620.
2	A	1	MNO Co.					$ 4,000.
		2	PRQ Co.					750.
		4(Total)						4,750.
2	B	1	U. S. Treasury notes					$ 175.
		2	Jones Mfg. Co.					50.
		3	Savings Bank					186.90
		4(Total)						411.90
2	E	1						$50,000.
		2						18,000.
		3						32,000.
		4						2,000.
		6						1,500.
2	F	1	Bldg.	$7,500.	$1,800.	$500.	$500.	
		2						$4,700.
2	G	2	Net wagering income					$ 600.
2	Total							$11,961.90
2	H	Col. 1 & 2			Bldg.—1908			
		3, 4 & 5		$81,000	$68,100		$12,900	
		6, 7 & 8		45	7 & 1/6		$ 1,800	
2	I	1	Col. 4 Sundry repairs					$ 500.
		2	Col. 5 Real estate taxes					500.
	J	1	Mary Taxpayer, etc.					
3	Cont	1	Church					1,500.
		2	University fund					8,000.
			Allowable					6,639.29

3	Int.	1	On insurance loans	300.
		2	On tax deficiency	150.
			Total	450.
3	Taxes	1	Real estate	850.
		2	Personal property taxes	50.
		3	Automobile license	35.
		4	Sundry	375.
			Total	1,310.
3	Losses	1	Loss from fire less recovery of $500.	$ 600.
			Total	600.
3	Medical	1	Hospitalization insurance	$ 75.
		2	Hospital, etc.	4,700.
		3	Less—Recovery through suit	(1,200.)
			Net	3,575.
			5% of item 4, page 1	2,213.10
			Allowable	1,361.90
			Total deductions	10,361.19

No. 2 (18 points) (Required)

THE HOWBURNE CORPORATION
Cash Flow Statement
Year Ended December 31, 1951

CASH WAS DISBURSED FOR:		
Purchase of marketable securities		$ 24,692
Payment of dividends (see computation 2)		178,095
Purchase of property, plant and equipment (3)		269,395
Purchase of 50 shares of preferred stock for retirement		5,450
Total disbursements		$477,632
NET CASH WAS PROVIDED BY OPERATIONS (SEE SCHEDULE 1)		128,374
Operations failed to provide sufficient cash in the amount of		$349,258
THIS DEFICIENCY WAS MET BY:		
Receipt of cash from:		
Long-term borrowing (bank loans)	$ 50,000	
Sale of 1,801 shares of common stock (4)	199,831	
Sale of marketable securities (5)	89,297	$339,128
Decrease in cash balance		10,130
		$349,258

(SCHEDULE 1)

THE HOWBURNE CORPORATION
Income Statement Adjusted to Cash Basis
Year Ended December 31, 1951

	Per Income Statement	*Adjustments to Cash Basis* *Add*	*Deduct*	*Cash Result*
INCOME				
Gross operating income (1)	$2,410,655			
Increase in trade receivables—uncollected			$ 84,621	$2,326,034
Non-operating income, including dividends and interest	21,708			21,708
Total income	$2,432,363			$2,347,742

DEDUCTIONS				
Operating charges:				
Materials and supplies used	$ 870,531			
Decrease in inventories			36,737	
Decrease in trade payables		$145,558		$ 979,352
Wages and salaries	906,387			
Increase in accrual unpaid			1,107	905,280
Provision for depreciation charged to operations	114,079			
Book charge, no cash required			114,079	—
Taxes, other than federal income	26,221)			
Estimated federal income tax	284,442)			
Decrease in tax liability		3,886		314,549
Other operating charges	33,762			
Bad debts—book charge			14,053	
Decrease in accrued items		2,320		
Decrease in prepaid items			2,685	19,344
Interest charges	1,297			
Increase in interest liability			454	843
Loss on investments	6,016			
No cash required			6,016	—
Total deductions	$2,242,735			$2,219,368
NET INCOME (after taxes)	$ 189,628			$ 128,374

Supporting Computations

(1) CASH PROVIDED BY GROSS OPERATING INCOME:

Per income statement		$2,410,655
Deduct—Increase in net receivables	$70,568	
Accounts written-off	2,605	
Increase in uncollectibles	11,448	84,621
Cash provided		$2,326,034

(2) CASH DISBURSED FOR PAYMENT OF DIVIDENDS:

Increase in retained earnings	$13,198	
Add back—Charge for cost of preferred stock cancelled over paid-in value	200	$ 13,398
Less—Net income for 1951		(189,628)
Dividends declared—1951		($ 176,230)
Add—Decrease in dividend liability		(1,865)
Cash paid		($ 178,095)

(3) CASH DISBURSED FOR PURCHASE OF PROPERTY, PLANT AND EQUIPMENT:

Increase in net balance	$ 155,316
Add—1951 depreciation credited to net asset	114,079
Cash paid	$ 269,395

(4) CASH PROVIDED BY SALE OF COMMON STOCK:

Par value of 1,801 shares sold		$ 180,100
Add—Excess paid-in over par:		
Increase in paid-in surplus	$19,481	
Amount charged to paid-in surplus for 50 shares of preferred stock cancelled	250	19,731
Cash provided		$ 199,831

(5) CASH PROVIDED BY SALE OF MARKETABLE SECURITIES:

Decrease in asset balance	$ 70,621
Add—Purchase of securities	24,692
Cost of securities sold	$ 95,313
Less—Loss on sale	6,016
Cash provided	$ 89,297

No. 3 (12 points) (Optional)

THE SPECIALTY SHOPS COMPANY — JOHN MANN, RECEIVER

Realization and Liquidation Account

February 5, 1952, to April 30, 1952

Debits			*Credits*		
ASSETS TO BE REALIZED:			LIABILITIES TO BE LIQUIDATED:		
Accounts receivable	$ 5,928		Accounts payable	$15,987	
Merchandise	16,536		Notes payable	3,500	
Prepaid expenses	704		Accrued wages, taxes, etc.	1,275	
Fixtures (net)	8,539	$31,707	Accrued rent	600	$21,362
ASSETS DISCOVERED:			LIABILITIES DISCOVERED:		
Accounts receivable		423	Wages		125
SUPPLEMENTARY CHARGES:			LIABILITIES INCURRED:		
Expenses of liquidation	$ 1,245		Rent accrued	900	
Rent	900		Interest accrued	70	970
Interest	70		ASSETS REALIZED:		
			Accounts receivable	$ 1,882	
LIABILITIES LIQUIDATED:			Merchandise	9,108	
Accrued wages and taxes		1,028	Fixtures	1,000	11,990
LIABILITIES NOT LIQUIDATED:			ASSETS NOT REALIZED:		
Accounts payable	$15,987		Accounts receivable	$ 3,728	
Notes payable	3,500		Merchandise	8,226	
Accrued wages, taxes, etc.	372		Prepaid expenses	704	
Accrued rent	1,500		Fixtures	4,105	16,763
Accrued interest	70	21,429	LOSS ON REALIZATION		5,592
Total		$56,802			$56,802

SCHEDULE OF GAIN AND LOSS ON REALIZATION

Loss on accounts receivable	$ 741	
Loss on fixtures	3,434	$4,175
General expenses of liquidation		1,245
Rent		900
Interest		70
Total		$6,390
Gain on merchandise		798
Loss on realization		$5,592

THE PROBLEM permits the use of a worksheet showing similar information. The least formal presentation which seems to meet this requirement must identify the transactions in such a manner as to make preparation of the formal statement possible directly from the worksheet. The worksheet on page 100 is an example of minimum presentation.

Worksheet Form

		Balance	Miscellaneous		Cash		Realization		Balances
Assets		2/5/52	Charges	Credits	Receipts	Payments	Loss	Gain	4/30/52
Cash—Balance, Feb. 5, 1952	$ 764	$ 764							
Receipts	11,990								
	$12,754								
Disbursements	2,273								
Balance	$10,481								$10,481
Accounts receivable		5,928							
Discovered			(1) $ 423						
Collected					(4) $ 1,882				
Written off							(4) $ 741		3,728
Merchandise		16,536							
Proceeds of sale					(2) 9,108				
Gain on sale								(2) $ 798	8,226
Prepaid expenses		704							704
Fixtures		12,342							
Proceds of sale					(3) 1,000				
Loss on sale							(3) 3,434		
Transfer of accumulated depreciation on asset sold				(3) $ 942					6,966
Reserve for depreciation (may be netted against fixtures)		(3,803)							
Reduction of assets sold			(3) 942						(2 861)
		$32,471							$27,244
Liabilities									
Accounts payable		$15,987							$15,987
Notes payable		3,500							3,500
Accrued wages, taxes, etc.		1,275							
Payments						(5) $1,028			
Discovered				(5) 125					372
Interest accrued during period							(7) 70		70
Accrued rent		600							
Additional accrued during period							(7) 900		1,500
Expenses of liquidation						(6) 1,245	(6) 1,245		
		$21,362							$21,429
Net Worth									
Capital stock		$10,000							$10,000
Earned surplus		1,109	(5) 125	(1) 423					
Net loss on realization								5,592	(4,185)
		$11,109							$ 5,815
		$32,471	$1.490	$1,490	$11,990	$2,273	$6,390	$6,390	$27,244

No. 4 (12 points) (Optional)

Trans. No.	General Fund Dr.	General Fund Cr.	Other Funds Affected
Ex.	2	4	H
1	9	11	G
2	11	1	
3	11	2	T
4	12	8	
5			A, D
6			A, B
7	5	7	
8	6	13	
9	7	5)	
	6	13)	
10	7	5)	D
	6	13)	
11	6	2	E
12	2	12	
13	2	10	
14	2	11	T
15	6	4	T
16	3	2	F
17	2	10	D
18			H
19	13	2	H
20	2	8	

No. 5 (12 points) (Optional)

Year of Payment	*Amount of Payment*	*Present Value of $1.00*	*Amount Needed on Jan. 1, 1962*
1963	$ 5,000	$.9662	$ 4,831.00
1964	7,000	.9335	6,534.50
1965	10,000	.9019	9,019.00
1966	14,000	.8714	12,199.60
1967	16,000	.8420	13,472.00
1968	20,000	.8135	16,270.00
1969	25,000	.7860	19,650.00
1970	22,000	.7594	16,706.80
1971	17,000	.7337	12,472.90
1972	12,000	.7089	8,506.80
1973	8,000	.6849	5,479.20
1974	5,000	.6618	3,309.00
1975	2,000	.6394	1,278.80
1976	2,000	.6178	1,235.60
	$165,000		$130,965.20

Amount of an annuity of $10,000 for 10 years at 3½%	117,314.00
Balance required	$ 13,651.20
Present worth of $1.00 discounted for 10 years at 3½%	.7089
Payment required on Jan. 1, 1952	$ 9,677.34

Accounting Practice—Part II

November 6, 1952, 1:30 to 6 p.m.

No. 1 (12 points)

F AND T

Computation of Inventory and Possible Inventory Shortage

December 31, 1951

Gross sales (See Schedule)		$51,403
Returns	$ 95	
Discounts	272	
Net sales		$51,036
Inventory—1/1/51 (at cost)		$ 6,256
Purchases (See Schedule)	$38,647	
Returns	272	38,375
Goods available for sale		$44,631
Less—Cost of goods sold, computed as 65% of net sales		33,173
Inventory—12/31 (computed)		$11,458
Inventory—12/31 (physical, at cost)		4,442
Possible shortage in inventory		$ 7,016

Computation of Gross Sales

Cash collections from customers	$49,851
Less—Collection of prior charge-off	148
	$49,703
Increase in balance of receivables	1,189
Accounts written off	216
Returns credited to accounts	23
Cash discounts allowed	272
Gross sales	$51,403

Computation of Purchases

Payments to creditors			$38,970
Returns to vendors			272
			$39,242
Net decrease in accounts payable:			
Notes and accounts 1/1		$9,622	
Notes included therein:			
Paid 1951	$4,000		
Balance 12/31	3,000		
Total	$7,000		
Issued 1951	3,000	4,000	
Accounts 1/1		$5,622	
Accounts 12/31		5,027	595
Purchases			$38,647

No. 2 (18 points)

a.(1)

7% cumulative preferred stock	$300,000	
Premium on preferred stock	22,470	
Retained earnings	97,530	
Bonds payable		$300,000
5% preferred stock		120,000
To record the issuance of bonds in exchange for old preferred stock and the issuance of new preferred in settlement of dividends in arrears on old preferred.		

The question is raised as to whether either the new preferred stock or the bonds are issued at a premium or discount in this exchange. In a "package" exchange of this type, such a possibility must be recognized. The preferred stockholders paid a premium for their original stock. If the securities issued are only worth the par or face value, the preferred stockholders are recovering only $15,000 of this premium or they are taking some reduction in accumulated dividends. The above entry assumes that they recover the full amount of original premium but not the full $105,000 of dividends and that new issues are at par or face value.

Retained earnings	$163,660	
Goodwill		$ 50,000
Property, plant and equipment		17,800
Allowance for depreciation		85,400
Other current assets		10,460
To charge the write-downs to retained earnings.		
Common stock	$198,430	
Paid-in surplus (surplus from restatement of value of common stock)		$198,430
To reduce common stock to a stated value of $50 per share.		
Paid-in surplus	$ 85,120	
Retained earnings		$ 85,120
To eliminate the deficit in retained earnings against the surplus arising from restatement of common stock.		

a.(2)

THE MANCETT CORPORATION

Balance-Sheet

April 30, 1952

ASSETS

Cash	$ 39,980	
Other current assets	253,090	$ 293,070
Property, plant, and equipment*	$1,440,931	
Allowance for depreciation**	601,501	839,430
		$1,132,500

LIABILITIES AND CAPITAL

Current liabilities		$ 138,870
5% debenture bonds		300,000
5% noncumulative preferred stock, $10 par	$ 120,000	
Common stock, $50 per share stated value	450,000	
Paid-in surplus	113,310	
Retained earnings (arising since 4/1/52)	10,320	693,630
		$1,132,500

* At cost, less a write-down of $17,800 as a result of appraisal and estimates of useful value on April 1, 1952.
** Increased by additional allowance of $85,400 as a result of appraisal and estimates of useful value on April 1, 1952.

b. The general rule applicable to the first two items requires that, when material items which should have been adjusted in the restatement of assets and liabilities are found to have not been correctly stated, the items be considered as a portion of the paid-in surplus created in reorganization. Both of the first two items are adjustments of paid-in surplus under this rule. The entries to correct the items are as follows:

		Dr.	Cr.
(1)	Paid-in surplus	$14,496	
	Retained earnings		$14,496
	To transfer the charge for prior years' income tax to paid-in surplus. This item should have been estimated and set up at date of reorganization, if possible.		
(2)	Retained earnings	$20,387	
	Paid-in surplus		$20,387
	To transfer the credit arising from sale of an asset written down in reorganization to the surplus balance at date of reorganization.		

In an accounting reorganization, asset valuations should be restated in conformity with estimates of useful value. Such restatements should include write-ups of values, when justified, as well as write-downs. Since the sale of equipment resulting in the "gain" of $20,387 took place so soon after the reorganization—within nine months at most—the appraised valuation of such equipment at date of reorganization appears to have been in error. The $10,000 write-down, through increased depreciation allowance, was not justified and the additional $10,287 might have been added to the asset.

(3) The third item may be correctly charged. It is not related to the reorganization. If it is so material as to result in a distortion of net income for the year if carried through net income, it can be left as a direct charge to retained earnings. If its inclusion in income charges would not result in distortion of net income for the year, it should be transferred to income and out of retained earnings.

(4) The fourth item is properly charged, unless the dividends declared were in excess of the earnings since date of reorganization, as dividend distributions should be charged to retained earnings.

No. 3

THE SUPERIOR HAMMER COMPANY

Cost and Production

For October, 1952

FOUNDRY DEPARTMENT

	Units	Amount	Per Unit
Material	22,500	$ 1,248.00	$.0554667
Labor—Removing and cleaning castings	21,500	1,095.00	.0509302
Labor—Other	22,400	3,285.00	.1466518
Overhead—Removing and cleaning castings	21,500	328.50	.0152791
Overhead—Other	22,400	985.50	.0439955
Total		$ 6,942.00	$.3123233
Assignment of costs:			
Transferred to assembly	20,000	$ 6,246.47	$.3123233
In process—Cleaned	1,500	468.48	.3123233
In process—Poured (material)	1,000	55.47	.0554667
In process—Poured (labor and overhead)	900	171.58	.1906473
Total		$ 6,942.00	

ASSEMBLY AND FINISHING DEPARTMENT

	Units	Amount	Per Unit
Material—Heads	20,400	$ 6,374.71	$.3124858
Material—Handles	19,800	9,876.00	.4987879
Labor	19,800	1,834.00	.0926263
Overhead	19,800	1,252.00	.0632323
Total		$19,336.71	$.9671323
Assignment of costs:			
Completed and transferred	19,800	$19,149.22	$.9671323
Heads	600	187.49	.3124858
Total		$19,336.71	

In the above solution, unit costs have been carried to 7 decimal places. However, candidates were required to use only 5 decimal places.

Theory of Accounts

November 7, 1952, 1:30 to 5 p.m.

No. 1 (10 points)

a.		
Cash	$9,000	
Crane capital		$9,000
Austin capital	333	
Bradford capital	333	
Crane capital		666

This method would reflect a bonus given to Crane to induce him to invest. There are a number of possible reasons for such a bonus. For example, all assets of the original partnership could have been properly valued, but a shortage of working capital imperiled continued operations. Rather than risk liquidation of the business and substantial losses which might be involved, the partners might give Crane a bonus to induce him to invest.

b.		
Cash	$9,000	
Goodwill	1,000	
Crane capital		$10,000

This method would be appropriate if Crace brought goodwill into the partnership. This goodwill could measure an established clientele or personal following in a profession, trade, or business.

c.		
Austin capital	$1,000	
Bradford capital	1,000	
Assets (itemized)		$2,000
Cash	9,000	
Crane capital		9,000

This method of recording Crane's admission to the partnership would be appropriate if the assets were overstated on the books of the original partnership. Examples of such overstatement are: inadequate allowance for doubtful accounts and inadequate past depreciation of fixed assets.

If the partnership books had been kept on a cash basis, the entry of accruals might result in a reduction of net assets.

No. 2 (10 points)

While in practice all businesses do expense certain items which meet all of the theoretical tests as being fixed assets, such treatment is supported only on practical grounds. The corporation should consider the following factors in setting a minimum amount below which expenditures will not be capitalized:

a. *Materiality.* A minimum of $1,000 would be inappropriate in a small corporation. Not only must the materiality of the minimum amount be considered, but also the aggregate materiality of all items below the minimum. Materiality must be considered from both the balance-sheet and income statement viewpoints.

b. *Regularity of expenditures.* If expenditures below the minimum are made with regularity, annual income will be substantially the same as though these costs were capitalized and then depreciated.

c. *Depreciation rates.* The higher the depreciation rates, the higher the appropriate minimum. There is less reason to capitalize an item with a one-year life than to capitalize an item with a ten-year life.

d. *Need for control.* Records must be kept to account for corporate property. Significant items should be capitalized to measure accountability and permit control. Control by other means than through the financial accounting records, however, if often feasible.

e. *Income-tax effects.* The policy of capitalizing as compared with "expensing" minor expenditures possibly may have some effect on the income-tax expense incurred as of any particular date. Capitalizing tends to increase taxes in earlier years of the business' life.

f. *Cost of keeping records.* The cost of maintaining detailed property records is a factor which always tends to favor "expensing" items, subject to the limitations of the other factors listed.

g. *The custom of the industry.* Comparability of the practice of the business and similar enterprises in the same industry should be considered. By custom, some types of business do not capitalize items which would be capitalized by companies in other areas of activity.

No. 3 (10 points)

Ideally, the method employed in assigning factory departmental overhead to jobs or products should be based upon a factor which is common to all jobs or products and which measures accurately the extent to which the indirect manufacturing costs were utilized in their production. In practice, however, prevailing conditions are seldom such that the selection of an ideal base is possible, for most manufacturing enterprises make diverse products, the processing of which utilizes factory overhead in varying degrees and causes its incurrance in different ways. Such manufacturers have to choose between the use of several bases, each of which is suitable for a single expense or group of expenses, and the use of a single base which results in a reasonable, although not precise, assignment of overhead. One of the oldest and most widely-used bases is direct labor cost.

In considering the advantages and disadvantages of using direct labor cost as a base for assignment of overhead to jobs or products, it must be recognized that no single base is ideal for all types of overhead. This is so because factory overhead includes a variety of costs, the amount of and manner of incurrence of which vary. For example, some manufacturing expenses such as property taxes, property insurance, building depreciation, superintendent's salary, etc., are fixed as functions of time and are not appreciably affected by other factors such as amount or rate of production. On the other hand, other elements of overhead are variable to some extent and are more or less directly affected by fluctuations in production, for example: power, repairs and maintenance of machinery, depreciation of machinery based upon usage, factory supplies, material handing, etc. In many instances, there is no completely satisfactory basis for assigning costs of even one type to either departments or to jobs or products because even the "variable" expenses may be a mixture of fixed and variable elements. Such expenses as material handling and power have a fixed element which would continue to be incurred even if production were suspended temporarily.

The principal advantage of the direct labor cost basis is the ease of using it. Direct labor cost must be identified anyway, so its use does not require any additional records. In many cases, it approximately measures the amount of time, space, and equipment used on each job or product. The method has the additional advantage of being easily understood by supervisors and other operating personnel

who may need to use the results. Also, it is divisible into small units which can be identified with specific products or operations.

There are many possible criticisms of the direct labor cost method. If wage rates vary within the department it is not so good a basis for certain costs as the direct labor hour method. The use of direct labor cost as a base implies that the higher-paid workers as such are responsible for a greater actual incurrence of overhead than are the lower-paid workers. Not only is this not necessarily true, but the contrary might well be true; e.g., where lower-paid workers require greater supervision. This fault would cause distorted allocation unless all jobs or products utilized the same amount of each type of labor.

Where much of the cost in a department is related to machine usage, the labor cost method may not be related very closely to cost incurrence. Also, in instances where the various jobs or products are not processed on the same equipment or in the same manner in a department, distortion may result. The jobs which require a large amount of equipment are likely to be undercharged, and the jobs requiring much labor but little equipment are likely to be overcharged.

Direct labor cost may not be closely related to material handling or charges based on space. If a considerable portion of the costs are related to time or are "fixed costs" and the rate of production varies from month to month, the inventories will show wide cost fluctuations. However, the same criticism is applicable to most methods.

No. 4 (12½ points)

a. The rules dealing with the recognition of purchase commitments in accounting statements are:

1. The amount and existence of commitments which are abnormal or not in the usual course of business and which are material in amount should be disclosed by a footnote to the financial statements.

2. Losses which are expected to arise from firm, uncancellable, and unhedged purchase commitments should be given current recognition. The losses should be measured in the same way as inventory losses and, if material, should be disclosed separately in the income statement.

b. 1. Debit—Loss on purchase commitments. xxx
Credit—Allowance for loss on purchase commitments. xxx

2. The loss should be shown in the income statement in the same manner as inventory losses under the cost or market rule, or in other deductions, if material. If significant in amount, it should be separately disclosed.

The allowance for loss should be shown as a current liability in the balance-sheet. It cannot be deducted from inventory because it is unrelated to the inventory on hand. It is not a surplus reserve and to show it as such would mean, in effect, that no loss is being currently recognized. There is a liability under the purchase contract and the amount set up is a portion of that liability. It represents the portion for which no corresponding asset will be received.

3. When the goods are received in November, 1952, the allowance for loss should be closed against the purchases account and the goods should be taken into inventory at the net cost.

No. 5 (15 points)

a. Installment note payable $448
Interest and finance expense 48
Cash $448
Deferred interest and finance charges 48

b. In view of the fact that the interest and finance charge is several times larger than normal interest, there may be a question as to the desirability of deferring the additional charge which is in excess of a reasonable charge for interest. Probably a portion of the charge is related to the credit risk taken by the vendor and to the collection and account servicing cost. These amounts might be changed off immediately. However, such elements exist to some extent in all installment loans and commonly are treated as a part of interest expense.

Simplicity is the principal argument for straight-line amortization of the deferred charge.

Against the straight-line method is the argument that it ignores the realities of the situation. The interest and finance charge is considered to be a money cost when it is deferred and should be related to the use of the money. The liability on principal is approximately twice as great at September 30, 1952, as it will be at September 30, 1953. Therefore, the monthly charge for October, 1952, should be approximately twice as great as for October, 1953. In other words, the expense for October, 1952, should be approximately $92 while the charge for October, 1953, should be approximately $46.

A theoretically correct amortization of the deferred amount can be obtained fairly easily by the use of the "payment outstanding method." Using this method, we would write off 24/300 of the amount the first month, 23/300 the second month, etc., until the last month when only 1/300 would be amortized.

c. *Arguments for the treatment proposed by the corporation*: The balance-sheet and income statement are financial statements. Therefore, financial nature rather than legal form should control accounting treatments. In this case, the trucking company gave a non-interest bearing note for $10,752. The financial significance of the transaction would have been identical if the corporation had given an interest bearing note for $9,600. Since the alternatives are different in form rather than substance, their accounting treatments should be the same. Liability for interest is set up as the interest accrues, not in advance. The note for $10,752 includes interest of $1,152 which should not be shown as a liability until it "accrues."

Other arguments for the corporation's treatment are the objections to the possible alternative treatments. One alternative is to show the $1,152 as a deferred charge. Against this is the objection that the deferred interest is not an asset. It is not prepaid interest, but instead is unpaid interest. Another alternative is to show the entire $1,152 as an expense in the period in which the note was given. This clearly distorts the financial picture and has no support among accountants. The alternative of including the amount as a part of equipment cost is not considered as acceptable since the asset should be valued at its "cash" price.

Arguments against the treatment proposed by the corporation: There is an actual legal liability of $10,752. This argument is based on the legal form of the transaction rather than its financial nature. Since the final liability is the face of the note, the $1,152 cannot be presented as a deduction from the note. Presentation as a deferred charge is proper because the balance-sheet is essentially a statement of residuals—most assets are costs which will be charged against future income.

No. 6

A person who is considering making an investment in common stock of a corporation is usually interested in varying degrees in the rate and stability of the return he will receive, in the prospect of appreciation in price of the stock, and in the safety of his principal over a long term. Opinions on these matters can be formed in part from information in accounting statements but there are many factors which are beyond the scope of the usual accounting statements.

We must first recognize that accounting statements are historical in nature and only to a limited extent (and then principally through certain assumptions made by accountants) are they projections into the future. They are not budgetary in their approach and do not purport primarily to predict future earnings or future values. Second, they are restricted as to their inclusiveness. They do not attempt to record many kinds of economic values or to record certain kinds of economic events. For example, accounting statements do not record directly the value of a competent, efficient, and loyal labor force, or of a capable administrative organization. The general reputation of the business and the reputation of its products or services are not usually reflected directly in the statements, even though these intangibles may materially affect the future outlook for the business.

Third, the statements are based on certain assumptions and postulates. These preclude the complete measurement of the effect of price level changes. Plant, property, and equipment are usually stated at cost less amortization of cost, with the result that the amounts in the statements may be far from the amounts which reflect present values or present expiration of values. The method of accounting for inventories may or may not be subject to the same limitation. Probably either the inventory amounts in the balance-sheet or the amounts charged against income will be either above or below current values or costs. As a result of this limitation, it is usually impossible to determine what portion of the income is ordinary and likely to continue and what portion is fortuitous and not likely to recur.

Fourth, the determination of income for any one period involves a number of estimates and judgments because complete information as to the final effect of many transactions is not available until long after the end of the period. The determination of annual income is difficult because a business is a continuous operation, the result of which is difficult to measure in terms of short periods of time. A more accurate measurement may be obtained over a longer period. Consideration of the entire earning history of a company and the study of the change in financial position during a number of periods is likely to be more revealing and to afford a better basis for forecasting the future than consideration of the statements for only two years.

In any particular situation there is likely to be a number of factors which an investor should consider apart from the financial statements, even for a period of years. The ability, experience, and continuity of management is an important factor in most situations. The trend of the industry and of the company under consideration will merit attention. The diversification of products and the competitive position of the company are factors which may not be reflected fully in past performance.

No. 7 (15 points)

a. The proposed change would have no effect on the amount of net income or the amount of cost of goods sold. The composition of the cost of goods sold section, however, would be changed. Depletion would be separated from other costs and the amounts of opening and closing inventories would be changed.

The table in Exhibit I compares the two methods with an assumed depletion cost of $1 per unit, other assumed costs of $3 per unit and with an asumed amount for mining properties.

In the year of the change, the amount of net income and cost of goods sold should not be affected. Units which had been charged with depletion prior to sale would not be charged with depletion a second time.

b. The effect of the proposed change would be a reduction of inventory and an increase of mining property to the extent of depletion charges related to closing inventory.

The following table compares the two methods on the assumption that depletion cost is $1 per unit and other costs are $3 per unit:

	Number of Units	*Proposed Method*	*Present Method*
Inventory	90	$ 270	$ 360
Mining property		100.530	100,440
Total		$100,800	$100,800

Total current assets would be changed but total assets would not be affected. There would be no effect on retained earnings.

c. *Arguments in favor of the controller's proposal*: In many states, no provision for depletion is necessary to determine profits available for dividends. In view of this, it can be argued that depletion should not be merged with other costs but should be stated separately.

It is also true that the estimate of depletion may be little better than a sheer guess. In view of this, it can be argued that depletion should not be merged with other costs but should be stated separately.

Inventories are carried at lower amounts if depletion is not included in their cost. Production costs are more useful to management if depletion is not included, thus showing "out-of-pocket" (exploitation) cost. Management will know that any excess of selling price over this amount is a recovery of investment or is profit. The theory of permanence of the enterprise need not apply to a mining concern. Significant statement presentation of inventories is, therefore, presentation of quantities and "out-of-pocket" costs. This is true, it can be argued, from the viewpoints of management, stockholders, and creditors.

Arguments against the controller's proposal: Depletion is an element of cost and should be recorded as such. The fact that depletion is an estimate does not eliminate the need nor the usefulness or recording all costs. Profits can be adjusted to show the maximum amount of dividends which legally can be paid, or other statements may be prepared to show the legal status of earnings.

No. 8 (15 points)

a. The third of the suggested dates (the dates on which the options are exercised) seems to have little significance. The parties have previously done all that each of them agreed to do and the rights became the property of the grantee when he completed his services. Any delay on his part in exercising the option represents a speculation on his part. Whether his speculation is or is not profitable for him has no bearing on the amount of compensation.

The possibility that accounting recognition is required as to the agreement as of the date the agreement was made has some merit. It is at that time that both the corporation and the officers must have appraised the value of the options and of the officer's services and both decided that the agreement was advantageous from their standpoints. At that point there was a meeting of minds and such an agreement must have been based on their opinions of value as of that date. The principal objection to the use of that date is that no services have been performed. However, it is not uncommon to set a value on services prior to performance. In fact, it is the most usual procedure.

The date on which the services are completed had the option rights become the property of the officers has some logical support as the time for accounting recognition of the transaction. At that time all conditions have been met by the grantee. An unqualified obligation now exists on the part of the corporation.

b. In measuring the amount of compensation to be recorded, the rule set forth in AIA Research Bulletin No. 24 applies: "When property is given for services, the cost of those services would be determined by their fair value or by the fair value of the property given, whichever is the more clearly evident."

It would be unusual in a circumstance such as exists here to have a direct measure of the cash value of the services. If such measure were available, it should be used since it would be the most appropriate measure. Ordinarily it is necessary to use the value of the option granted as a measure of the value of services received. Determining the value of the option is not simple. While stock rights may have a market value, there is not likely to be a "market" for options issued to one or a few individuals. Frequently such options are not transferable. Rights frequently sell above their theoretical value and presumably stock options would also sell above their theoretical value. However, the best that usually can be done is to record the services at the theoretical value of the options. That value might be considered to be the difference between the market value for stock and the price at which it can be acquired under the option. However, if the options represented a right to a relatively large amount of stock, there might be some dilution effect to exercise of the options which would reduce their value.

No. 9 (15 points)

a. The ten items listed may be classified as shown in Exhibit II.

b. Conversion of normal tax net income into excess-profits net income is identical under either method, with one exception: the adjustment for interest on borrowed capital. Under the invested capital method the interest deduction is reduced by 75 per cent of interest on borrowed capital. Under the income method interest deduction is reduced by 75 per cent of the interest applicable to *any increase* in borrowed capital during the *current year*. The interest deduction for the current year is 5 per cent of $1,000,000 or $50,000. The adjustment required if the invested capital method is used is 75 per cent thereof or $37,500. Inasmuch as borowed capital has remained unchanged since 1950, no interest adjustment is required if the income method is used. Comparing the $25,000 greater credit under the invested capital with the $37,500 increase in excess-profits net income under that method, it is obvious that the credit computed under the income method would be used.

EXHIBIT II: ANSWER TO QUESTION 9a

Affect Income Method Exclusively	*Affect Invested Capital Method Exclusively*	*Affect Both Methods*
a	j	c
b		f
d		g
e		
h		
i		

Auditing

November 6, 1952, 9 a.m. to 12:30 p.m.

No. 1 (12 points)

1. Prepare a worksheet showing terms, notes payable at the beginning of the period, additions, payments, notes payable at the end of the period, accrued interest at the beginning of the period, interest expense, interest paid, and accrued interest at the end of the period.
2. Analyze the general ledger accounts for notes payable, interest expense, and accrued interest, and tie in with schedule.
3. Examine paid notes; check to schedule.
4. Confirm bank notes when confirming cash. If it is deemed appropriate, confirm notes payable to suppliers at the balance-sheet date.
5. Examine correspondence in connection with the issuance of notes to suppliers. Examine the minutes for authorization of loans from banks.
6. Tie in the issuance of the notes to cash receipts or reductions of accounts payable. Tie in payments on the notes and interest payments to cash disbursements. If there are a large number of transactions, limited tests might be sufficient. The cash books might be scanned and tests made from entries to notes payable record.
7. Make independent calculations of interest accruals and interest expense.
8. Review transactions subsequent to the audit date for possible payments on notes which had not been set up at the balance-sheet date. If it is deemed desirable, prepare an aging schedule of accounts payable and investigate overdue accounts for possible issuance of notes. Confirmation of some of the accounts payable could also be desirable.
9. Classify the notes payable for balance-sheet presentation. If collateral was given with any of the notes, suitable balance-sheet disclosure must be made.

No. 2 (12 points)

a. We have examined the balance-sheet of ABC Company as of July 31, 1952, and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards except as noted in the next paragraph.

The terms of our engagement did not provide for confirmation of receivables or verification of inventory quantities. The limited scope of our audit prevents us from expressing an opinion on the statements as a whole. However, the auditing procedures which we did follow disclosed no exceptions to the consistent application of generally accepted accounting principles.

(*Note*: Details of auditing procedures which were followed can be given with appropriate comments on the audit findings.)

b. With the omission of two basic auditing procedures (confirmation of receivables and physical observation or tests of inventory), it would be extremely difficult to arrive at an informed opinion as to the fairness of receivables, inventories, and related accounts. The absence of a perpetual inventory in this case makes it virtually impossible to arrive at an informed opinion.

Inventories and receivables are probably material in amount for a company of this type. Their combined weight in the statements is probably so great that, without an opinion as to their fairness, it is impossible to have an opinion on the statements as a whole.

An auditor cannot restrict the use of his report once it leaves his hands. He must, therefore, assume that the report will reach third parties. Bulletin 23 of the committee an auditing procedure of the American Institute of Accountants deals with auditor's report and states a rule which protects third parties who might see the report: "The independent certified public accountant shall not express the opinion that financial statements present fairly the position of the company and the results of its operations in conformity with generally accepted accounting principles, when his exceptions are such as to negative the opinion, or when the examination has been less in scope than he considers necessary to express an opinion on the statements as a whole. In such circumstance the independent certified public accountant should state that he is not in a position to express an opinion on the financial statements and indicate clearly his reasons therefor."

No. 3 (15 points)

1. Contribution checks should be made payable to the hospital or to a specific fund and not to an individual. This should be specified in all advertising and mailings and on all pledge forms.

Purpose—To prevent diversion of checks to other than the hospital or fund bank account.

2. Receipt forms should be prenumbered and solicitors should give receipts for all collections they make. A carbon copy should be provided which will go to the cashier.

Purpose—To provide a check on the collections made by solicitors. Since most contributors would insist on having a receipt, the carbon copy provides some check on receipts issued.

3. All mail solicitation should be accompanied by a return envelope addressed to the Fund Office Box Number.

Purpose—To prevent contributions going to the general offices of the hospital and thereby not being adequately controlled.

4. Incoming campaign mail should go to a post office box to which access can be gained only by two persons jointly. All such mail should be opened and listed by two persons jointly.

Purpose—To prevent, except for possible collusion, the diversion of contributions received by mail.

5. Solicitors might be asked to submit their report in sealed envelopes on which the contents are listed on the outside. These envelopes are then opened at the fund office and the contents checked to the listing, which is saved as supplemental material supporting pledges and contributions received through solicitors.

Purpose—To afford a control over contributions turned in to the cashier by solicitors and place responsibility in case shortages develop.

6. All cash should be deposited daily.

Purpose—To safeguard cash and to provide parallel bank records for comparison with fund records.

7. Acknowledgement should be mailed from the fund office for all contributions received. Notice that this will be done should be included in all advertising and mailings and on all pledge forms. If prenumbered acknowledgements are not used, a prenumbered receipt form should be included.

Purpose—To provide opportunity for contributors to cooperate in checking or accounting for contributions.

8. A list of contributors, together with amounts contributed, should be published, if permissable.

Purpose—Same as for No. 7

9. Employees handling cash should be bonded.

Purpose—To provide for recovery of losses. Also to provide for bonding company's investigation into employees' integrity.

10. Solicitors should report in reasonable detail each case encountered in which a contributor reports that he has already contributed. Such reports should be checked against the records.

Purpose—To provide additional source of check against previous solicitations.

No. 4 (12 points)

a. Such a comment is not justification enough to support an accusation of the employee, but should be followed up to the extent necessary to protect the client. The amount involved is not signficant from the standpoint of the statements. The primary purpose of counting such funds is to assist the client through checking on the employees.

However, in view of the doubt which may exist the senior should extend his investigation somewhat. He might examine some of the reimbursement vouchers more carefully. He should probably make a second surprise count of the petty cash fund before the audit is completed. One of the client's internal auditors, or some other appropriate employee, might accompany the senior on the second count.

b. The senior should prepare a correcting entry and submit it to the client's accounting officer or he should ask the company's accountant to prepare the necessary entry for posting as of the year-end. The auditor's working papers should have the correction posted to the trial balance or balance-sheet and income account working papers. Errors of this type are, at worst, merely indicative of carelessness. The error is subject to factual detemination and adjustment can be made with a minimum of discussion with company employees.

c. While the information discovered indicates the possibility of fraud, it is by no means conclusive. The matter must be followed up tactfully until more definite facts are established. The situation should be reported to the supervisor or partner in charge of the audit. The treasurer should be asked to explain the discrepancies but should not be accused of any wrongdoing at this point. If a completely satisfactory explanation is not obtained, an appropriate officer of the client should be notified. In the absence of a satisfactory explanation a special investigation

outside the scope of an annual audit might be indicated. However the senior would not undertake such an investigation on his own initiative. Such a procedure would be arranged for between the principal of the firm and an officer of the client.

No. 5 (12 points)

The procedures by which unrecorded liabilities might be discovered can be classified conveniently under these three general headings.

1. Inquire of those who might know about liabilities:
   a. Inquire of the client's officers — obtain a "liability certificate" from the client.
   b. Inquire of the client's bank—request information about liabilities when confirming cash balances.
   c. Inquire of the client's lawyer—request information about law suits and other contingencies.
   d. Inquire of the client's suppliers and other creditors—confirm accounts and notes payable.
2. Review the client's records:
   a. Review creditors' statements—look for invoices which were not entered by client.
   b. Review invoices entered after the audit date—look for those which apply to the period under audit.
   c. Compare receiving tickets with recorded purchases—look for goods received but not recorded.
   d. Scan cash receipts book—look for unusual entries which might indicate borrowing.
3. Investigate the possible sources of liabilities:
   a. Accruals—check interest accrued on notes payable, wages accrued, taxes accrued, etc.
   b. Guarantees, pensions, special deposits, etc.—look for guarantees and estimate the liability; determine existence of pension contracts and calculate any liabilities thereunder; determine existence and amount of special deposits by customers.
   c. Purchase of fixed assets—look for contracts and installment notes payable.
   d. Purchases—review purchase orders, look for commitments, etc.

No. 6 (15 points)

The auditor should satisfy himself that there are adequate provisions for the following:

1. Supervising and instructing:
   a. Assigning responsibility and authority to an inventory supervisor and departmental assistants.
   b. Instructing foremen, perpetual inventory clerks, and other workers.
   c. Providing for correct identification and description of inventory items.
   d. Writing of clear instructions.

Reasons for inclusion—to assure that inventory is taken in the manner planned, to eliminate ambiguities, and to assure that safeguards are observed.

2. Pre-sorting of stock:
   a. Separating damaged or obsolete goods.
   b. Bringing similar goods together, so far as is practicable.
   c. Stacking and storing properly.

Reasons for inclusion—To assure that items are not overlooked, to assure that obsolete or damaged goods are so noted, and to facilitate counting.

3. Providing for cut-offs:
   a. Scheduling and controlling movement of goods between departments.
   b. Arranging for departmental shutdowns.
   c. Controlling goods received, transferred, and shipped during count.

Reasons for inclusion—To assure that goods are not counted more than once and that goods are not overlooked.

4. Providing for control of tags and of count procedures:
   a. Listing all locations where stock may be found.
   b. Using prenumbered tags and accounting for all numbers.
   c. Reviewing of tagged items by supervisor before tags are removed.
   d. Reporting items in perpetual records for which no count is received.

Reasons for inclusion—To assure that all items are counted and that all counts are recorded.

5. Providing for two independent counts, if no book record of quantities is maintained:
   a. Comparing counts with each other and with perpetual records.
   b. Recounting where necessary.

Reason for inclusion—To assure reliability of count.

6. Including any changes based on previous year's experience.

Reason for inclusion—To improve plan by improved procedures.

No. 7 (12 points)

1. Discuss the transaction with a company official.
2. Review the correspondence relating to the purchase.
3. Review any contract associated with the purchase.
4. Check the minutes of the directors' meetings for authorization of the purchase and approval of the valuation.
5. Examine the stock certificate book and determine that the shares were issued.
6. Inquire about changes in production methods and about new products. Information of this kind will also be obtained in connection with other phases of the audit; for example, in connection with the audit of inventories.
7. Discuss the basis of valuation with company officials. If there is no basis for determining the fair market value of the process, it should be valued on the basis of the fair market value of the stock issued. This value may be more or less than the par value as used by the company.
8. When analyzing expense accounts, watch for related expenses, including possible royalty payments. Such expenses or royalty payments might indicate that the journal entry did not reflect the entire transaction.

9. It might be possible to obtain confirmation of the transaction from the inventor.

10. Determine the reasonableness of any proposed amortization policy and set up amortization for the period.

No. 8

1. False	6. False	11. True	16. True
2. False	7. False	12. True	17. True
3. True	8. True	13. False	18. False
4. False	9. True	14. False	19. False
5. False	10. True	15. False	20. False

Commerical Law

November 7, 1952, 9 a.m. to 12:30 p.m.

Group I

No. 1 (10 points)

a. Yes, B could have recovered from M. B was a holder in due course under the facts of the problem. The defense which M would interpose is improper completion of a properly delivered, incomplete paper. Such a defense is not effective against a holder in due course. (Uniform Negotiable Instruments Act, Section 14.)

b. Yes, C may collect from M. The defense which M would interpose is improper completion of a properly delivered, incomplete paper. Such a defense is not effective against a holder in due course or one who derives his title through a holder in due course and who is not himself a party to any fraud or illegality affecting the instrument. Although C is not a holder in due course, since the instrument was indorsed specially to B and required further indorsement to negotiate it, he is a transferee of an unindorsed order paper and, as such, has the rights of the transferor, B, who was a holder in due course under the facts. While in some jurisdictions an instrument payable to order must be indorsed before the holder can maintain an action thereon in his own name, one of the rights acquired by the transferee, C, is the right to have the indorsement of the transferor, B. (Uniform Negotiable Instruments Act, Sections 14, 49, 58.)

c. No, C may not recover from D. A check of itself does not operate as an assignment of any part of the funds to the credit of the drawer with the bank, and the bank is not liable to the holder unless and until it accepts or certifies the check. (Uniform Negotiable Instruments Act, Section 189.)

No. 2 (10 points)

a. C has a lien for $200 on the truck. When a negotiable bill of lading is issued, the carrier has no lien on the goods mentioned therein, except for charges on those goods for freight, storage, demurrage and terminal charges, and expenses necessary for the preservation of the goods or incident to their transportation subsequent to the date of the bill, unless the bill expressly enumerates other charges for which a lien is claimed. Accordingly, C has a lien on the truck for the $200 transportation charge only. (Uniform Bills of Lading Act, Section 26; Federal Bills of Lading Act, Section 25.)

b. Yes, C must deliver. A carrier, in the absence of some lawful excuse, is bound to deliver goods upon a demand made by the holder of a negotiable bill of lading accompanied by an offer in good faith to satisfy the carrier's lawful lien upon the goods, and an offer in good faith to surrender, properly indorsed, the bill which was issued for the goods. Both of these conditions have been fulfilled here. The facts do not set out a lawful excuse for a failure to deliver on the part of C. (Uniform Bills of Lading Act, Section 11; Federal Bills of Lading Act, Section 8.)

c. No, B would not have any rights against C. A carrier is justified in delivering goods to the consignee named in a non-negotiable bill of lading without the surrender of the bill of lading, if the carrier is unaware that the consignee is not lawfully entitled to the goods. (Uniform Bills of Lading Act, Sections 12, 13; Federal Bills of Lading Act, Sections 9, 10.)

No. 3 (10 points)

a. Yes. An inquiry from the offeree to the offeror seeking a possible change in the offer is not a rejection. Had the reply of the offeree changed the terms of the offer there would have been a rejection and no later acceptance could be made. Here the suggestion of the offeree was turned down by the offeror, and the second letter from the offeree resulted in an acceptance. There was a contract. (Clark on Contracts, 4th. Ed., Section 22; Selections from Williston on Contracts, Revised Ed., Sections 51, 79; Restatement of the Law of Contracts, Pages 46, 47.)

b. No. If the offeree varies the means of communication in his acceptance from that used or authorized by the offeror in making the offer or customary in similar transactions at the time when and the place where the offer is received, the acceptance is not effective unless and until it is received. Here the offer was made by mail, the purported acceptance by telegram. The offeror never authorized acceptance by telegram and the facts in the case do not indicate that custom authorized the use of the telegraph as a means of communication or acceptance. Therefore, since the telegram was never received, there was no contract for want of a valid acceptance. (Selections from Williston on Contracts, Revised Ed., Sections 81, 82, 83; Restatement of the Law of Contracts, Sections 64, 66.)

c. Yes. A mistake made by the offeror in his statement of the price, if the mistake is unknown to the offeree, does not affect the validity of an acceptance on the basis of the stated price. But where the mistake is so great that the offeree ought to have known that there must have been a mistake in the wording or the offer, he cannot by accepting bind the offeror to the terms erroneously stated. An error of $500 on a $10,500 transaction would probably not be large enough to fall within this exception. (Selections from Williston on Contracts, Revised Ed., Sections 94, 95; Clark on Contracts, 4th Ed., Page 265; Restatement of the Law of Contracts, Section 503.)

d. No. A revocable offer can be accepted only by or for the benefit of the person to whom it is made. (Selections from Williston on Contracts, Revised Ed., Section 80; Restatement of the Law of Contracts, Section 54.)

No. 4 (10 points)

a. Unanimous consent of all partners who have not abandoned the business is required for any of the following acts:

1. Assigning the partnership property in trust for creditors or on the assignee's promise to pay the debts of the partnership.
2. Confessing a judgment.
3. Submitting a partnership claim or liability to arbitration or reference.
4. Disposing of the goodwill of the business.
5. Doing any other act which would make it impossible to carry on the ordinary business of the partnership.

(Uniform Partnership Act, Section 9 (3).)

b. The liabilities of the partnership shall rank in order of payment, as follows:

1. Those owing to creditors other than partners.
2. Those owing to partners other than for capital and profits.

3. Those owing to partners in respect of capital.
4. Those owing to partners in respect of profits.

(Uniform Partnership Act, Section 40 (b).)

c. Dissolution without violation of the agreement between the partners is caused by:

1. The termination of the definite term, or particular undertaking, specified in the agreement;
2. The express will of any partner when no definite term or particular undertaking is specified;
3. The express will of all the partners who have not assigned their interests or suffered them to be charged for their separate debts, either before or after the termination of any specified term or particular undertaking;
4. The expulsion of any partner from the business bona fide in accordance with such a power conferred by the agreement between the partners.

(Uniform Partnership Act, Section 31 (1).)

d. When partnership property and the individual properties of the partners are in the possession of a court for distribution, partnership creditors shall have priority on partnership property and separate creditors on individual property, saving the rights of lien or secured creditors. Where a partner has become bankrupt or his estate insolvent, his separate property, after first being applied to claims of his separate creditors, is next subject to claims of partnership creditors and then to claims owing to the partners by way of contribution.

(Uniform Partnership Act, Section 40 (h), (i).)

No. 5 (10 points)

a. The state of incorporation and a stockholder of the corporation have the right to object to an ultra vires act. The state of incorporation may show its objection to ultra vires acts (1) by bringing a quo warranto proceeding in a court of law designed to either forfeit the charter of the Corporation or to oust the Corporation from further exercise of the unauthorized powers, or (2) by suing in a court of equity to enjoin the ultra vires act. A non-assenting stockholder of a corporation may enjoin a threatened ultra vires act or, by a stockholders' suit, may sue to set aside a completed ultra vires transaction. (Fletcher, Cyclopedia Corporations, Perm. Ed., Section 3453, 3457, 4855.)

Y Corporation may not legally object to the act on the ground that it is ultra vires. As a general rule, a plea of ultra vires cannot be interposed by a stranger not a party to the contract. (Fletcher, Cyclopedia Corporations, Perm. Ed., Section 3448.)

b. No, he cannot recover the consideration he gave. As a general rule, where fully executed on both sides an ultra vires contract cannot be attacked as such by either party therto. (Fletcher, Cyclopedia Corporations, Perm. Ed., Section 3497.)

c. Yes, the contract may be avoided by the corporation. As a general rule, contracts wherein a director is interested adversely to the corporation are not void, but are merely voidable at the option of the corporation, unless such deal-

ings are otherwise void as being in contravention of public policy. When such a contract is challenged the burden is on the director not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. If in the transaction between an interested director and his corporation the corporation is represented by other directors, the transaction is valid and cannot be set aside merely because of the relationship of the parties, if the directors sustain the burden of proving good faith and inherent fairness from the viewpoint of the corporation. But where a director is the other party to a transaction with his corporation, or is the agent of the other party and he votes in favor of the transaction as a director of his corporation and his vote is necessary to make up a majority necessary to pass the resolution, there is no question but that the transaction is included in the class where the director deals with himself and represents both sides of the transaction, and hence is voidable at the option of the corporation merely because of the relationship of the parties without any other ground and regardless of the fairness or good faith of the transaction. (Fletcher, Cyclopedia Corporations, Perm. Ed., Sections 913, 931, 936.)

Group II

No. 6 (10 points)

a. Some of the duties and obligations of a principal to his agent are:

1. To pay for the agent's services.
2. To reimburse him for expenses incurred on behalf of the principal.
3. To indemnify him against losses and liabilities properly incurred in the execution of the agency.
4. To perform the agency contract according to its terms.
5. To use care to inform the agent of risks of physical harm or pecuniary loss which, as the principal has reason to know, exist in the performance of authorized acts and which he has reason to know are unknown to the agent.
6. To refrain from unreasonably interfering with the agent's work.
7. To compensate him for physical injuries received in the principal's service as the result of the principal's negligence.

(Restatement of the Law of Agency, Sections 432 *et seq.;* Machem, Outlines of Agency, 3rd Ed., Section 403 *et seq.*)

b. An agent's lien is his right to retain possession of money, goods, or documents of the principal, of which he has gained possession in the proper execution of his agency, until he is paid the amount due him from the principal as compensation for services performed or as indemnity for money advanced or liability incurred by him in connection with such things. (Restatement of the Law of Agency, Section 464.)

c. The relationship of a public accountant to his clients is that of an independent contractor, not that of an employee. An independent contractor is one who exercises some independent calling, occupation, or employment in the course of which he undertakes, supplying his own materials, servants, and equipment, to accomplish a certain result, not being subject while doing so to the

direction and control of his employer, but being responsible to his employer for the end to be achieved, and not for the means by which he accomplishes it. A public accountant is retained by his client on a contract to perform certain services. These services are of a professional character and require the exercise by the accountant of his specialized, professional knowledge and of his judgment, objectively and independent of the direction or influence by his client. (*Ipswich Mills v. Willon,* 260 Mass. 453, 157 N.E. 604 (1927); Restatement of the Law of Agency, Section 2; Mechem, Outlines of Agency, 3d Ed., Section 20.)

No. 7 (10 points)

a. A's performance would not be excused. The promise to erect an apartment building according to specifications does not require any personal action by A. This is not a case of true impossibility, as A could employ someone else to build according to the specifications. If this contract had called for personal services, illness or death would have excused performance by A. (Selections from Williston on Contracts, Revised Ed., Sections 411, 1932, 1940; Clark on Contracts, 4th Ed., Section 258; Restatement of the Law of Contracts, Page 856.)

b. A's performance would not be excused. As a general rule, in the absence of provision to the contrary a contractor assumes the risk that performance may become more difficult and expensive than it was at the time the contract was entered into. (Selections from Williston on Contracts, Revised Ed., Section 1963; Clark on Contracts, 4th Ed., Section 258.)

c. A's performance would be excused. As a general rule, where domestic law forbids or prevents the performance of a promise, legal when made, the promisor is freed from liability. (Selections from Williston on Contracts, Revised Ed., Section 1938; Restatement of the Law of Contracts, Section 458; Clark on Contracts, Section 258.)

d. A's performance would be excused. An adjudication of bankruptcy may be treated as an anticipatory breach of a contract. If, however, O's trustee in bankruptcy first gives security for the payment of the contract price of $100,000, A's performance will not be excused. The adjudication of bankruptcy absolves A from the duty of giving credit. A's duty of performance is discharged unless security for the payment of the contract price is given. (Restatement of the Law of Contracts, Section 287; Selections from Williston on Contracts, Revised Ed., Sections 880, 1327.)

No. 8 (10 points)

a. X has the better right to the lamp. Where a person having sold goods continues in possession of the goods, the delivery or transfer by that person, or by an agent acting for him, of the goods under a sale to any person receiving and paying value for the same in good faith and without notice of the previous sale, has the same effect as if the person making the delivery or transfer were expressly authorized by the owner of the goods to make the same. (Uniform Sale Act, Section 25.)

b. Unless a different intention appears, when goods are delivered to the buyer on trial and a time has been fixed for their return or acceptance title passes to

the buyer on the expiration of such time if the buyer has neither returned the goods nor given notice of rejection prior to such expiration. Uniform Sales Act, Section 19, Rule 3 (2); 46 American Jurisprudence, Sales, Sections 493, 494.)

No. 9 (10 points)

a. They differ in that join-stock associations, unlike corporations, are not legal entitles, Hence, while corporations may sue or be sued in the corporate name, a joint-stock association must sue or be sued in the name of all the members composing it. Similarly, a joint-stock company, unlike a corporation, cannot acquire and convey property by its common name, but title must be taken and conveyed by members as individuals or by an officer in trust for the members. Joint-stock companies derive their existence from the contract of individual members, while corporations derive their existence from the sovereign power of the state. Hence, a joint-stock association, unlike a corporation, may be dissolved at any time without the consent of the state, and where the business in which it is engaged is not affected with a public interest, it is free from the inquisitional power of the state which normally extends over corporations. The members of a joint-stock association are individually liable for its debts, whereas corporate stockholders generally have no personal liability for the corporate debts.

The resemblances between a joint-stock association and a corporation include the following: the use of a common name; a capital stock, the shares of which are transferable; the right of continuous succession; and management of the business by directors or trustees and officers. (Fletcher, Cyclopedia Corporations, Perm. Ed., Sections 21, 8283; 30 American Jurisprudence, Joint-Stock Companies.)

b. 1. A municipal corporation is a public corporation created by government for political purposes and having subordinate and local powers of legislation. (Black's Law Dictionary.)

2. Quasi-corporations have been defined as those bodies or municipal societies which, though not vested with the general powers of corporations, are yet recognized by statutes or immemorial usage as persons or aggregate corporations, with precise duties which may be enforced and privileges which may be maintained by suits at law. They have limited powers and are not full corporations. The characteristics of quasi-corporations partake rather of those of public or quasi-public corporations than of those of private corporations. "They possess," it has been said, "some corporate functions and attributes, but they are primarily political subdivisions—agencies in the administration of civil government—and their corporate functions are granted to enable them more readily to perform their public duties." The governor of a state has been held to be a quasi-corporation sole, with respect to his office, so that when, under a statute, bonds are made payable to him, he or his successor may sue thereon in his official capacity. There are some public officers, or public boards that are given corporate capacity for certain particular specified ends, and thus are quasi-corporations. They are authorized to sue and be sued as artificial persons, and are given the power to make contracts in reference to public affairs. (Fletcher, Cyclopedia Corporations, Perm. Ed., Section 64.)

c. With reference to the laws and the courts of any given state, a domestic corporation is one created by, or organized under, the laws of that state; a foreign corporation is one created by or under the laws of another state, government, or country. (Black's Law Dictionary.)

d. The agreements of a promoter do not become binding upon a corporation, unless a statue or its charter makes the corporation liable, or until the corporation expressly or impliedly adopts, accepts, or ratifies them. (Fletcher, Cyclopedia Corporations, Perm. Ed., Section 205, *et seq.*)

No. 10 (10 points)

a. A holder in due course is a holder who has taken the instrument under the following conditions:

1. That it is complete and regular upon its face;
2. That he became the holder of it before it was overdue, and without notice that it had been previously dishonored, if such was the fact;
3. That he took it in good faith and for value;
4. That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.

(Uniform Negotiable Instruments Act, Section 52.)

b. A protest is a formal declaration under the hand and seal of the notary making it, annexed to the bill of exchange or containing a copy thereof, which specifies the time and place of presentment, the fact that presentment was made and the manner thereof, the cause or reason for protesting the bill, and the demand made and the answer given, if any, or the fact that the drawer or acceptor could not be found. Protest may also be made by any respectable resident of the place where the bill is dishonored, in the presence of two or more credible witnesses. (Uniform Negotiable Instruments Act, Sections 153, 154.)

Where a foreign bill appearing on its face to be such is dishonored by non-acceptance, it must be duly protested for non-acceptance, and where such a bill which has not previously been dishonored by nonacceptance is dishonored by non-payment, it must be duly protested for nonpayment. If it is not so protested, the drawer and indorsers are discharged. Where a bill does not appear on its face to be a foreign bill, protest thereof in case of dishonor is unnecessary. (Uniform Negotiable Instruments Act, Section 152.)

c. Where a check is certified by the bank on which it is drawn, the certification is equivalent to an acceptance. A check of itself does not operate as an assignment of any part of the funds to the credit of the drawer with the bank, and the bank is not liable to the holder unless and until it accepts or certifies the check. (Uniform Negotiable Instruments Act, Sections 187, 189.)

d. In the event of non-payment by the maker, the holder of a negotiable instrument must take the following steps before the indorsers can be held:

1. Make presentment for payment to the maker.
2. If the instruments is a foreign bill, duly protest it for non-payment.
3. Give notice of dishonor by non-payment to the indorsers.

(Uniform Negotiable Instruments Act, Sections 70, 89, 152.)

e. 1. Present it on Tuesday, June 5, its maturity date.

2. Present it on Thursday, December 26, as December 25 (Christmas) is a holiday.

3. Present it on Monday, July 7. Friday, July 4, is a holiday; July 5 is Saturday, and July 7, Monday, is the next business day.

(Uniform Negotiable Instruments Act, Section 85.)

No. 11 (10 points)

1. (b) need not.
   (Tiffany on Real Property, New Abridged Ed., Section 790; 45 American Jurisprudence, Records and Recording Laws, Section 81.)
2. (a) does not.
   (Tiffany on Real Property, New Abridged Ed., Section 662; 16 American Jurisprudence, Deeds, Section 77.)
3. (a) is.
   (Tiffany on Real Property, New Abridged Ed., Section 667; 16 American Jurisprudence, Deeds, Sections 62, 63.)
4. (b) does not.
   (16 American Jurisprudence, Deeds, Section 55.)
5. (b) does not.
   (16 American Jurisprudence, Deeds, Section 91.)
6. (a) must.
   (Tiffany on Real Property, New Abridged Ed., Section 693; 16 American Jurisprudence, Deeds, Section 111.)
7. (a) is.
   (16 American Jurisprudence, Deeds, Section 9.)
8. (b) valid.
   (16 American Jurisprudence, Deeds, Section 87.)
9. (a) has.
   (See annotation 172 A.L.R., pp. 20, 21, 100, 102; 14 American Jurisprudence, Covenants, Conditions and Restrictions, Sections 69, 99, 100.) In the interest of accuracy a few words of explanation are given in regard to this answer. The substance of the question is whether a grantor who has conveyed land by a warranty deed has breached the warranty when it develops that there is a recorded unpaid mortgage on the land which was not mentioned in the deed. Generally speaking, the obligation under a convenant of warranty in a deed is not that the covenantor is the true owner, or that he is seized in fee, with right to convey, but that he will defend and protect the convenantee against rightful claims of all persons thereafter asserted. It is generally recognized that an eviction is necessary to constitute a breach of a covenant of warranty but the authorities are not unanimous in regard to the question of whether an actual eviction is necessary and as to what constitutes a constructive eviction sufficient to constitute a breach of the covenant of warranty. Some authorities hold that the mere existence of an outstanding encumbrance at the time the deed is delivered constitutes a

constructive eviction giving the vendee a right of action on the covenant of warranty. Other authorities require more than this before the right of action arises. On the other hand, if the warranty were in the form of a covenant against encumbrances, it would be breached when made if there were a mortagage of record.

10. (b) cannot.
(Tiffany on Real Property, New Abridged Ed., Section 659; 16 American Jurisprudence, Deeds, Sections 218, 219.)

No. 12 (10 points)

1. False. (Title 11, United States Code Annotated, Section 21(a)(4).)
2. False. (Title 11, United States Code Annotated, Section 21.)
3. False. (Title 11, United States Code Annotated, Section 110.)
4. True. (Title 11, United States Code Annotated, Section 107(a)(1).)
5. False. (Title 11, United States Code Annotated, Section 110.)
6. False. (Title 11, United States Code Annotated, Section 104.)
7. True. (Title 11, United States Code Annotated, Section 35.)
8. False. (6 American Jurisprudence, Bankruptcy, Section 958.)
9. True. (Title 11, United States Code Annotated, Section 35(a)(2).)
10. False. (Title 11, United States Code Annotated, Section 32(c)(5); 6 American Jurisprudence, Bankruptcy, Section 113.)

Examination Answers, May, 1953

Accounting Practice—Part I

May 13, 1953, 1:30 to 6 p.m.

No. 1 (20 points)

AMOUNTS AND OTHER ITEMS TO BE ENTERED ON FORM 1065

Page	*Schedule*	*Line*			
1		Date	Nov. 1, 1951—Oct. 31, 1952		
		1, 3		$587,760	
		5		1,500	
		8		280	
		12	Bad debt recovery	1,000	
		13			$590,540
		14		$190,000	
		15		14,000	
		17		56,820	
		19		3,000	
		20		28,680	
		21		6,500	
		24		47,400	
		25			346,400
		26			$244,140
		28			$ 26,000

2 A 4

Col. 1	*Col. 2*	*Col. 3*	*Col. 4*	*Col. 5*	*Col. 6*	*Col. 8*	
Office equipment	1/5/51	9/30/52	$16,000	$1,000	$12,000	$ 5,000	
$10,000 U.S. bonds	8/1/46	10/ 5/52	10,000		9,800	200	
$10,000 Illinois bonds	8/1/46	10/30/52	10,000		9,750	250	
1,000 shs. ABC Mutual Fund	8/1/46	10/30/52	40,000		19,950	20,050	
Capital gain—dividend received from ABC Mutual Fund, 1,000 shs. at $.50						500	26,000

2	C	State and local	$54,380
		Mexican sales	2,440
			$56,820

2 D

Col. 2	*Col. 3*	*Col. 5*	*Col. 6*
$244,140	$587,760	$7,590	$3,000

(Note: The box following the word "worthless" should be marked X.)

3 E

Col. 1	*Col. 2*	*Col. 3*	*Col. 4*	*Col. 5*	*Col. 8*	
Depreciable assets	1/5/51	$ 12,000	$ 476.19	$ 11,523.81	$ 523.81	(Sold 9/30/52)
	Various	143,000	19,523.81	123,476.19	28,156.19	
	Various	17,225	—	17,225.00		
					$28,680.00	

(Note: This solution assumes that a blanket rate of depreciation was used and that depreciation on the asset retired was taken from 1/1/51.)

Page	Schedule	Line			
3	F	*Col. 1*			
Administrative and selling expenses				$47,400	
	Total				$47,400
3	G		Red Cross	$ 3,000	
			Community Chest	5,000	
	Total				$ 8,000
3	H	1 and 7	Exempt		

Questions

1. 1/1/51
3. Partnership
4. Yes
5. Accrual
6. No inventories
7, 8. 9, and 10 may be left blank.

Page	*Schedule*	*Line*		*Col. 1*	*Col. 2*	*Col. 3*	*Col. 4*
4	I	1			$ 35,460		$ 21,970
		2			136,850		357,780
		4			50,000		
		5		$155,000		$160,225	
				20,000	135,000	47,680	112,545
		7			13,728		26,270
		8			$371,038		$518,565
		9			$ 51,838		$ 79,475
		11			22,200		50,530
		12			—		35,000
		13(a)	Smith	$ 73,000		$ 87,120	
		(b)	Jones	75,000		89,170	
		(c)	Brown	73,000		87,080	
		(d)	White	76,000	297,000	90,190	353,560
		14			$371,038		$518,565

			Col. 1	*Col. 2*	*Col. 3*	*Col. 5*	*Col. 6*	*Col. 7*
4	J							
		(a)	$73,000	$66,015	$ 7,570	$29,465	$30,000	$87,120
		(b)	75,000	66,065	7,620	29,515	30,000	89,170
		(c)	73,000	55,975	7,530	19,425	30,000	87,080
		(d)	76,000	56,085	7,640	19,535	30,000	90,190

				Col. 3	*Col. 4*	*Col. 6*	*Col. 7*	*Col. 9*
4	K							
		(a)	Smith	$ 65,945	$ 70	$ 6,500	$2,000	$1,700
		(b)	Jones	65,995	70	6,500	2,000	1,700
		(c)	Brown	55,905	70	6,500	2,000	1,700
		(d)	White	56,015	70	6,500	2,000	1,700
		Total		$243,860	280	$26,000	$8,000	$6,800

SUPPLEMENTARY COMPUTATIONS

For Schedule J—Column 2

Distribution of Ordinary Net Income

	Smith	*Jones*	*Brown*	*White*	*Total*
Interest allowance (4%)	$ 3,620	$ 3,670	$ 3,580	$ 3,690	$ 14,560
Salary allowance	10,000	10,000	—	—	20,000
	$13,620	$13,670			$ 34,560
Remainder equally	52,395	52,395	52,395	52,395	209,580
Ordinary net income (line 26, p. 1)	$66,015	$66,065	$55,975	$56,085	$244,140

For Schedule J—Column 3

Capital Gains and Nontaxable Income

Profit on sale of securities*	$10,000
Profit on sale of office equipment	5,000
Dividend from capital surplus of ABC Mutual Fund	500
Interest on State of Illinois bonds	300
Sub-total—shared equally	$15,800
Interest allowed on capital accounts*	14,560
	$30,360

Distributed as follows:	*Sub-Total*	*Interest*	*Total*
Smith	$ 3,950	$ 3,620	$ 7,570
Jones	3,950	3,670	7,620
Brown	3,950	3,580	7,530
White	3,950	3,690	7,640
	$15,800	$14,560	$30,360

For Schedule J—Column 5

Capital Losses and Unallowable Deductions

Excess of credit to reserve for doubtful accounts over amount reported in return	$ 4,590
Provision for possible devaluation of Mexican peso	10,000
Provision for contingencies	25,000
Mexican income taxes	6,800
Donations	16,990
Sub-total—charged equally	$63,380
Partners' salaries*	20,000
Interest allowed on capital accounts*	14,560
	$97,940

Distributed as follows:	*Sub-total*	*Salaries*	*Interest*	*Total*
Smith	$15,845	$10,000	$ 3,620	$29,465
Jones	15,845	10,000	3,670	29,515
Brown	15,845	—	3,580	19,425
White	15,845	—	3,690	19,535
	$63,380	$20,000	$14,560	$97,940

* Instructions have not been issued by the Treasury Department on the handling of certain debatable items in Schedule J. Accordingly, the following alternate treatments of those items may be acceptable:
1. Inclusion of interest on capital accounts in Column 4, or exclusion from Columns 3, 4, and 5 of Schedule J.
2. Reporting of capital gains in Column 3 on a tax basis.
3. Inclusion of partners' salaries among withdrawals (Column 6) instead of among unallowable deductions (Column 5).

No. 2 (12 points) ***(a)***

Item	*Effect(s)*
(1)	A, C, G, S, T.
(2)	F, G, S. Declaration and payment of a dividend payable in common shares to common shareholders results merely in an accounting transfer of capital from one classification of capital to another.
(3)	B, D, H. Receipt of this cash dividend, since no receivable had been recorded previously, would be recorded by a debit to cash and a credit to a revenue account.
(4)	S, T. Failure to declare a regular dividend on perferred stock creates a recognized arrearage. This arrearage would increase the amount to be assigned to preferred in a computation of the book value of common shares.
(5)	None of the listed effects. There is no accounting recognition of income from this transaction.

(6) D. In the usual situation where current assets exceed current liabilities, a reduction of both items by an equal amount results in an improved current ratio. This transaction had no effect on working capital or capital; they were reduced when the dividend was declared.

(7) S.

(b)

Item	*Answer*	*Formula*
(1)	b	$\dfrac{\text{Cash} + \text{net receivables}}{\text{Current liabilities}}$
(2)	e	$\dfrac{\text{Gross receivables}}{\text{Gross charge sales - charge returns \& allowances}} \times 365 \text{ (or 360) days}$
(3)	a	$\dfrac{\text{Cost of goods sold}}{\text{Average finished goods inventory}}$
(4)	b	$\dfrac{\text{Net income before federal income taxes} + \text{bond interest}}{\text{Bond interest}}$
(5)	d	$\dfrac{\text{Net income after federal income taxes}}{\text{*Preferred dividend requirement}}$
(6)	c	$\dfrac{\text{Net income after federal inc. taxes - *preferred dividend requirement}}{\text{No. of common shares outstanding}}$
(7)	e	$\dfrac{\text{Total capital - **preferred liquidating value}}{\text{No. of common shares outstanding}}$
(8)	a	$\dfrac{\text{Current assets}}{\text{Current liabilities}}$

* Preferred dividend requirement = No. of preferred shares outstanding × preferred dividend rate.
**Preferred liquidating value = No. of preferred shares outstanding × liquidating value per share.

No. 3 (18 points)

H & H LABORATORIES, INC.

Comparative Statement of Gross Profit Under Assumed Conditions for a One-Month Period

	By-product W (20%)		*By-product Clora-W (20%)*		*By-product Clora-W (30%)*	
	Pounds	*Amount*	*Pounds*	*Amount*	*Pounds*	*Amount*
Sales	8,640	$36,720	8,640	$36,720	7,560	$32,130
Cost of goods manufactured and sold:						
Raw materials	12,000	$12,000	12,000	$12,000	12,000	$12,000
Processing cost:						
Department 1	12,000	4,440	12,000	4,440	12,000	4,440
Department 2	12,000	4,560	12,000	4,560	12,000	4,560
Department 3	10,800	4,860	10,800	4,860	10,800	4,860
Department 4	8,640	3,888	8,640	3,888	7,560	3,402
Total		$29,748		$29,748		$29,262
Deduct value of by-product at point of separation (see schedule)	2,160	2,160	2,160	2,524	3,240	5,332
Cost of goods sold	8,640	$27,588		$27,224		$23,930
Gross profit	8,640	$ 9,132		$ 9,496		$ 8,200

Schedule of Values Assignable to By-Product

Sales	2,160	$ 2,160	1,944	$ 9,720	2,916	$14,580
Costs incurred:						
Material added	—	—	1,080	$ 540	1,620	$ 810
Processing cost—variable	—	—	3,240	3,564	4,860	5,346
Processing cost—fixed	—	—		3,092		3,092
Total	—	—		$ 7,196		$ 9,248
Net value at point of separation		$ 2,160		$2,524		$ 5,332

Accounting Practice—Part II

May 14, 1953, 1:30 to 6 p.m.

(a) No. 1 (16 points) (Required)

THE ROOFING CO., INC.

(1) **Schedule of Gross Fixed Asset Values**
As at December 31, 1952

	Basis		*Rehabilitation Cost*	*Value 12/31/52*
Land	Cost	$ 2,500	—	$ 2,500
Building	App. V.	25,000	$12,000	37,000
Equipment	App. V.	10,000	—	10,000
Trucks and autos	Cost	22,500	—	22,500
				$72,000

(2) **Computation of Total Flood Loss for 1952**

	Depreciated Cost Before Flood	*Appraisal Value After Flood*	*Loss*
Land	$ 2,500	$ 2,500	—
Building	39,400	25,000	$14,400.00
Equipment	12,825	10,000	2,825.00
Trucks and autos	20,250	21,000	—
Clean-up expense			3,000.00
Fixed charges for July			4,000.00
Loss on materials			2,450.00
Depreciation for July			562.50
Total flood loss			$27,237.50
Balance per ledger			6,450.00
Adjustment—J. E. #1			$20,787.50

(3) **Computation of Depreciation for 1952**

Building	*Period*	*Rate or Useful Life*	*On Asset Value As of*	*On Asset Value Amount*	*Depreciation*	
1/1–6/30	½ Yr.	3%	1/1	$40,000	$ 600.00	
7/1–7/31	1 Mo.	4%	7/1	25,000	83.33	
8/1–12/31	5 Mos	4%	8/1	25,000	416.67	
8/1–12/31	5 Mos.	299 Mos.	8/1	12,000	200.67	$1,300.67
Equipment						
1/1–6/30	½ Yr.	10%	1/1	13,500	$ 675.00	
7/1–12/31	½ Yr.	12½%	7/1	10,000	625.00	1,300.00
Trucks and autos						
1/1–12/31	1 Yr.	20%	1/1	22,500	$ 4,500.00	4,500.00
Total depreciation—1952						$7,100.67
Less—July depreciation charged to flood loss (J.E. #1):						
Building					$ 83.33	
Equipment					104.17	
Trucks and autos					375.00	562.50
Depreciation expense—1952						$6,538.17
Balance of depreciation account—after J.E. #1						6,487.50
Adjustment to depreciation account—J.E. #3						$ 50.67

Computation of Adjustment to Allowance for Depreciation

	Building	Equip-ment	Trucks and Autos
Reserve needed: 7/1/52–12/31/52	$700.67	$625	—
1/1/52–12/31/52			$4,500
Reserve balance after J.E. #1	600.00	675	4,500
Adjustment to reserve—J.E. #3	$100.67	$(50)	—

(b)

Bases of valuation:

1. *Land.* Appraisal value and cost are identical, and there was no flood loss.

2. *Building.* There are two ways of approaching the valuation of an asset which is to be substantially altered or rebuilt. One approach is to remove from the asset account all cost for that portion of the asset which will not be useful in the new asset. This approach would be most appropriate where the major portion of the original asset is retained in the rehabilitated asset. The second approach is to determine the value of the original parts which are still useful and add to that the cost of work done. This method is necessary where the rehabilitation work is extensive, and in all cases offers the advantage of insuring that the total recorded value is reasonable in relation to the new asset.

The first method, if followed in the present situation, might be considered to require the retirement of one-half of the net book value of the building and the addition of rehabilitation costs to the residual value. The second method would start the valuation of the rehabilitated building at the appraised value of the useful parts and add rehabilitation costs to that amount.

While there is strength in the argument that, if one-half of the value was lost, also one-half of the cost must have been lost, it can be argued equally well that, since $25,000 residual value remains to be recovered, the loss sustained cannot exceed the difference between that amount and the original cost of the asset less reasonable depreciation. While application of that procedure might result in a value in excess of original cost, there is adequate evidence to support the amounts, and the appraisal value selected would be an appropriate basis for valuation of the asset.

The decrease in estimated life of the building may raise a question as to whether the flood loss computation should not take that into account. After rehabilitation, the building's estimated life still has been reduced by about eight years or twenty-five per cent of the original estimated life. The valuation of the asset could be based on the present value of the series of services which will be obtained from it. That is always implicit in valuation to some degree and presumably has already been given some indirect consideration in the appraisal.

The entire $12,000 of rehabilitation cost is a proper addition to the asset value, since it consists of costs which were incurred in restoring the utility of the asset and is sufficiently material in amount to justify capitalization. The necessity of making this expenditure evidently was considered by the appraisers.

A question may be raised as to whether a portion (perhaps all, since there was no other production) of July's fixed overhead should be allocated to the cost of the asset. In ordinary construction of assets by company employees using company facilities and for company use, a reasonable proportion of overhead should be allocated to the cost of the assets produced. In this case, there was no additional fixed overhead incurred, and variable overhead costs are included in the $12,000 charge capitalized. Certainly, therefore, the allocation of all of July's fixed overhead to the asset would result in an excessive charge to the asset, and there is no basis for the determination of the amount of a reasonable portion. Since the nonrecovery of this fixed overhead was attributable to the flood, this fixed overhead is included properly in the flood loss total.

3. *Equipment*. The reasoning advanced for the selection of a basis of valuation for the building applies here.

4. *Trucks and autos*. Cost is the basis selected, since there was no flood loss sustained directly with respect to these assets. A question of apparent inconsistency may arise with respect to this selection. The appraisal values differed from the costs (and amortized costs) of the building, equipment, and trucks and autos. However, for the first two assets the appraisal values were selected as bases.

Accounting theory accepts the premise that assets should be carried at cost except in unusual circumstances. One such circumstance may be where cost cannot be determined for some reason. In the case of the building and the equipment, such a modification of original cost is required as to make necessary the acceptance of some reasonable "non-cost" value. However, there is no such necessity in the case of the trucks. Therefore, the original cost basis should be used for them.

(c)

Journal Entries

(1)

Flood loss	$20,787.50	
Allowance for depreciation—building	600.00	
Allowance for depreciation—equipment	675.00	
Building		$15.000.00
Equipment		3,500.00
Overhead expenses		3,000.00
Depreciation		562.50

To adjust flood loss account to total amount of loss [see Sch. a(2)], to write down assets accounts to residual cost [see Sch. a(1)], to reclassify clean-up expense charged to overhead, and to charge July depreciation [see Sch. a(3)] to flood loss.

(2)

Building	12,000.00	
Overhead expense		12,000.00

To reclassify labor, supplies used and overhead incurred in rehabilitating building.

(3)

Allowance for depreciation—equipment	50.00	
Depreciation	50.67	
Allowance for depreciation—building		100.67

To adjust allowances to proper amounts and depreciation to expense for the year exclusive of July [see Sch. a(3)].

No. 2 (6 points) (Required)

Computation of amortization:

Year	Amount Outstanding
1952-53	$ 800,000
1953-54	800,000
1954-55	800,000
1955-56	700,000
1956-57	600,000
1957-58	500,000
1958-59	400,000
1959-60	300,000
1960-61	200,000
1961-62	100,000
Total	$5,200,000

$34,600 divided by 5,200 = 6.653846 amortization for one year on each $1,000 of bonds outstanding. Amortization to December 31, 1952, is computed as follows:

$$\frac{800 \text{ @ } \$6.653846}{2} = \$2,661.54$$

Amortization for year ended December 31, 1958, is computed as follows:

Jan. 1 to July 1

$$\frac{500 \text{ @ } \$6.653846}{2} = \$1,663.46$$

July 1 to Dec. 31

$$\frac{400 \text{ @ } \$6.653846}{2} = 1,330.77$$

Total for 1958 $2,994.23

No. 3 (18 points) (Required)

(a)

RECONCILIATION OF INTER-COMPANY ACCOUNTS, DECEMBER 31, 1952

Davis Manufacturing Co., Inc.

Due from Midway

	Debit	Credit
Due from Midway Sales, Inc. (before adjustment)	$ 86,175.97	
Dividend receivable (J.E. #1)	1,000.00	
Collection of account receivable (J.E. #2)	1,800.00	
Sale of consigned merchandise (J.E. #4)	2,000.00	
Payment of 1951 Federal income taxs (J.E. #5)	14,000.00	
Due from Midway Sales, Inc. (adjusted)	$104,975.97	

Due from Kent

	Debit	Credit
Due to Kent Realty Corp. (before adjustment)		$ 1,475
Dividend receivable (J.E. #1)	$ 1,000	
Payment of 1951 Federal income taxes (J.E. #5)	7,000	
December rent due to Kent Realty Corp. (J.E. #6)		6,100
To balance		425
	$ 8,000	$ 8,000
Due from Kent Realty Corp. (adjusted)	$ 425	

Kent Realty Corp.

Due to Davis

	Debit	Credit
Due from Davis Manufacturing Co., Inc. (before adjustment)	$ 6,575	
Payment of 1951 Federal income taxes (J.E. #1)		$ 7,000
To balance	425	$ 7,000
	$ 7,000	$ 7,000
Due to Davis Manufacturing Co., Inc. (adjusted)		$ 425

Due to Midway

	Debit	Credit
Due to Midway Sales, Inc. (before adjustment)		$ 2,800
Loss on sale of fixed assets to Midway Sales, Inc. (J.E. #2)		700
Due to Midway Sales, Inc. (adjusted)		$ 3,500

Midway Sales, Inc.

Due to Davis	*Debit*	*Credit*
Due to Davis Manufacturing Co., Inc. (before adjustment)		$ 33,910.00
Collection of account receivable (J.E. #1)		1,800.00
Correction of charge to Davis Manufacturing Co., Inc. (J.E. #2)		5,000.00
Credit for sale of consigned merchandise (J.E. #3)		2,000.00
Payment of 1951 Federal income taxes (J.E. #4)		14,000.00
Unentered December 1952 purchase invoices (J.E. #7)		48,265.97
Due to Davis Manufacturing Co., Inc. (adjusted)		$104,975.97

Due from Kent		
Due to Kent Realty Corp. (before adjustment)		$ 800
Advance to Kent Realty Corp. (J.E. #2)	$ 5,000	
Adjustment of cost of furniture and fixtures acquired from Kent Realty Corp. (J.E. #5)	700	
December rent due to Kent Realty Corp. (J.E. #6)		1,400
To balance		3,500
	$ 5,700	$ 5,700
Due from Kent Realty Corp. (adjusted)	$ 3,500	

ADJUSTING ENTRIES AT DECEMBER 31, 1952

Davis Manufacturing Co., Inc.

(1)

Midway Sales, Inc.	$ 1,000	
Kent Realty Corp	1,000	
Dividend income		$ 2,000

To record dividends due from subsidiary companies, payable in January, 1953.

(2)

Midway Sales, Inc.	1,800	
Accounts receivable—customers		1,800

To record collection of account receivable by Midway Sales, Inc.

(3)

Cost of sales	1,400	
Merchandise inventory		1,400

To remove from December 31, 1952, inventory items sold by consignee.

(4)*

Midway Sales, Inc.	2,000	
Sales		2,000

To record sale of 100 radios at $20 each by consignee.

(5)

Midway Sales, Inc.	$14,000	
Kent Realty Corp.	7,000	
Federal income taxes payable		$21,000

To record amounts advanced for 1951 Federal income taxes of subsidiaries.

(6)

Rent expense	6,100	
Kent Realty Corp.		6,100

To record December rent due to Kent Realty Corp.

Kent Realty Corp.

(1)

Federal income taxes payable	$ 7,000	
Davis Manufacturing Co., Inc.		$ 7,000

To record payment of 1950 Federal income-tax liability by Davis Manufacturing Co., Inc.

(2)

Allowance for depreciation of furniture and fixtures	700	
Loss on sale of fixed assets	700	
Midway Sales, Inc.		700
Furniture and fixtures		700

To adjust for loss on sale of furniture and fixtures to Midway Sales, Inc., and to close out applicable accumulated depreciation.

Midway Sales, Inc.

(1)

Accounts receivable	$ 1,800	
Davis Manufacturing Co., Inc.		$ 1,800

To transfer to latter account amount collected on its behalf and incorrectly credited to accounts receivable.

(2)

Kent Realty Corp.	$5,000	
Davis Manufacturing Co., Inc.		$ 5,000

To reflect properly advance to Kent Realty Corp. incorrectly charged to latter account.

(3)**

Cost of consigned goods sold	2,000	
Davis Manufacturing Co., Inc.		2,000

To record amount due to consignee for 100 appliances sold at $20 each, and to record cost of the consigned goods sold.

The following entry may be made to separate the sales on the books if such separation is carried out for sales of consignment goods:

Sales	2,500	
Sales of goods on consignment		2,500

(4)

Federal income taxes payable	14,000	
Davis Manufacturing Co., Inc.		14,000

To record payment of 1951 Federal income-tax liability by Davis Manufacturing Co., Inc.

(5)

Kent Realty Corp.	700	
Furniture and fixtures		700

To adjust cost of furniture and fixtures acquired from Kent Realty Corp.

(6)

Rent expense	$ 1,400	
Kent Realty Corp.		$ 1,400

To record December rent due to Kent Realty Corp.

(7)

Purchases	48,265.97	
Davis Manufacturing Co., Inc.		48,265.97

To record unentered December, 1951, invoices of Davis Manufacturing Co., Inc.

* The following is an acceptable alternate entry:

Midway Sales, Inc.	2,000	
Commission expense	500	
Sales		2,500

** The following is an acceptable alternate entry:

Sales	2,500	
Commission income		500
Davis Manufacturing Co., Inc.		2,000

No. 4 (10 points) (Optional)

As the problem requirements for part "b" do not specify the preparation of a traditional form of statement, they apparently may be met by the preparation of a worksheet, of a formal "statement of affairs," or of such schedules as are presented in the following solution. From data developed by means of one of these approaches, the required percentage of probable payments can be computed. Some form of "deficiency account" apparently is necessary to satisfy the requirement of part "a."

a. **THE MACHINE MANUFACTURING COMPANY**

Statement of Deficiency to Unsecured Creditors

April 30, 1953

Estimated loss on asset disposition:			
Notes receivable—pledged			$ 2,500
Notes receivable—not pledged			3,500
Accounts receivable			23,240
Work in process			18,500
Raw materials			7,900
Supply inventory			5,450
Tools			11,700
Prepaid insurance			950
Machinery—not pledged			21,600
Machinery—pledged			8,200
Total			$103,540
Liability not recorded:			
Interest accrued			300
Total deductions			$103,840
Net worth:			
Common stock		$ 75,000	
Deficit		(39,150)	
		$ 35,850	
Asset not recorded:			
Interest accrued		800	
Gain on asset disposition:			
Land and buildings	$33,750		
Finished-goods inventory	800	34,550	71,200
Estimated deficiency to unsecured creditors			$ 32,640

b. Percentage of probable payments to unsecured creditors:

$$\frac{\text{Net free assets}}{\text{Unsecured claims}} = \frac{\$62,610}{\$95,250} \text{ or } 65.7\%$$

Supporting Schedules

Free assets		
Land and building		$ 3,200
Cash		2,700
Accounts receivable		16,110
Finished machines		12,800
Work in process		20,300
Raw material		8,000
Supplies		1,000
Tools		3,000
Machinery		9,000
		$76,110
Less priority claims		
Accrued salaries and wages	$8,850	
Accrued property taxes	2,900	
Employees' taxes withheld	1,150	
Accrued wage taxes	600	13,500
Net free assets		$62,610
Unsecured claims		
Notes payable—bank		$ 2,000
Notes payable—equipment		2,000
Notes payable—wholly unsecured		39,250
Accounts payable		52,000
		$95,250

No. 5 (10 points) (Optional)

a. *Computation of outside shareholders' equity in net assets*:

There are at least three approaches to this problem. The most common is to set up and solve two equations. This may be done with either one of two different pairs of equations as follows:

(1) Yet R equal net assets of R including investment but treating treasury stock as though it were cancelled. Outside shareholders then have 7/9 of the value to be computed for R. Also let S equal the corresponding value for S with outside holders having 4/9 of that value.

Equations are: R = $540,000 plus 5/9 S, and
S = $590,000 plus 2/9 R.

These equations may then be solved by addition, substitution, successive trials, etc., establishing that R equals $990,000 and S equals $810,000. The outside interest in R is $770,000 (7/9 of $990,000); the outside interest in S is $360,000 (4/9 of $810,000).

Proof:

Outside interests \$360,000 + \$770,000 = \$1,130,000
Net assets available \$540,000 + \$590,000 = \$1,130,000

The second pair of equations can be set up by including the treasury stock, in which case outside interests equal .4S and .7R. These equations are:

$$R = \$540,000 + .1R + .5S$$
$$S = \$590,000 + .1S + .2R$$

Solving produces values for R of \$1,100,000 and for S of \$900,000. We then have .7 of R equal to \$770,000 and .4 of S equal to \$360,000 as before.

(2) The problem also can be solved by the "equity ratio" method, which in effect pre-solves for the variables in the equations. This procedure (which might be done by the application of the rules of determinates) is useful where frequent consolidation of companies is to be made, but hardly seems appropriate in this instance. These ratios can be set out in tabular form as follows:

	D	*R*	*S*
Company R	71/81	63/81	8/81
Company S	71/81	35/81	36/81

(3) This problem can be solved by assuming liquidation and working out the amount to be received in liquidation. The procedure would involve the following basic pattern:

Distribute the assets of S (other than stock of R). This would give \$262,222.22 (4/9 of \$590,000) to outside interests.

Distribute the stock of R held by S, which should give 4/9 of 2/9 of that stock to outside holders, equal to 11.26645 per cent of the stock which would then be outstanding.

As a result of the distribution made by S, R will have \$867,777.78 of assets and on distribution will distribute \$97,777.78 to outside stockholders of S. This will give them \$360,000. The remaining \$770,000 of the combined assets of \$1,130,000 will have been distributed to stockholders of R.

b. *Computation of dividends to outside shareholders of R:*

Net income (after taxes), excluding dividends	\$53,000
Share of S dividends: 5/9 × \$18,000	10,000
Total dividend declaration	\$63,000
	× 7/9
Outside stockholders' dividends	\$49,000

No. 6 (10 points) (Optional)

The usual building and loan association may distribute profits by "declaring a dividend" at a fixed rate, transferring some balance of income to a reserve account or leaving it undistributed. Many such organizations issue stock at any date and use modified plans of distributing profits. However, there are two basic features involved in all distributions. One is the decision as to whether profits divided in any year are considered to have been permanently divided or whether past profits are redivided each year. The second feature is the method for equating the amount invested by each series of stockholders. Equating investment may be done with reasonable accuracy with less work than is required for the greatest

accuracy. Therefore, there are four basic methods, many variations of which may be found in use. Two methods involve redistribution of past profits, while two do not. Two involve exact computation of equated capital, while two do not. These four methods, identified by their historical names, are given here.

PARTNERSHIP METHOD

Series	*(1)* *Number of Shares*	*(2)* *Dues Paid*	*(3)* *Average Time*	*(4)* *Equated Earning Power* *(1)×(2)×(3)*
1	500	3	9½	$14,250
2	400	2	6½	5,200
3	300	1	3½	1,050
				$20,500

$$\frac{\$14{,}250}{20{,}500} \times \$317.30 = \$220.56 \text{ Earnings for Series 1}$$

$$\frac{\$\ 5{,}200}{20{,}500} \times \$317.30 = \$\ \ 80.49 \text{ Earnings for Series 2}$$

$$\frac{\$\ 1{,}050}{20{,}500} \times \$317.30 = \$\ \ 16.25 \text{ Earnings for Series 3}$$

This method uses the exact average time for the investment but redistributes all profits each year and does not give effect to compounding of earnings. It results in assigning an average rate of earnings to each series even though the earnings were at different rates in various years.

RICE'S METHOD

Series	*Shares*	*Dues Paid*	*Time*	*Equated Earning Power*
1	500	3	3	$4,500
2	400	2	2	1,600
3	300	1	1	300
				$6,400

$$\frac{\$4{,}500}{6{,}400} \times \$317.30 = \$223.10 \text{ Earnings for Series 1}$$

$$\frac{\$1{,}600}{6{,}400} \times \$317.30 = \$\ \ 79.33 \text{ Earnings for Series 2}$$

$$\frac{\$\ \ 300}{6{,}400} \times \$317.30 = \$\ \ 14.87 \text{ Earnings for Series 3}$$

This method, like the partnership method, redistributes earnings each year. It is less accurate as to time but easier to compute than the partnership method.

DEXTER'S METHOD

Series	Shares	Book Value Per Share at First of Year or Installments Paid This Year	Number of Months Average Time	Equated Earning Power
1	{ 500	$ 6.07	12 }	$ 75,420
	500	12.00	6½ }	
2	400	12.00	6½	31,200
3	300	6.00	3½	6,300
				$112,920

$\frac{\$75{,}420}{112{,}920} \times \$282.30 = \$188.55 + \$35.00$ (last year) $= \$223.55$ Earnings applicable to Series 1

$\frac{\$31{,}200}{112{,}920} \times \$282.30 = \$78.00$ Earnings applicable to Series 2

$\frac{\$6{,}300}{112{,}920} \times \$282.30 = \$15.75$ Earnings applicable to Series 3

This method considers the division of the profits of each year to be final and gives effect to the compounding of such earnings. Exact average time is used. This method is accurate in principle and gives each series only the benefit of the earnings arising during the period it is outstanding. Computations are more complex under it than under any of the other methods.

INVESTED CAPITAL METHOD

Series	Shares	Book Value Per Share at First of Year Plus One-half of This Year's Payments	Equated Earning Power
1	500	$12.07	$6,035
2	400	6.00	2,400
3	300	3.00	900
			$9,335

$\frac{\$6{,}035}{9{,}335} \times \$282.30 = \$182.50 + \$35.00 = \$217.50$ Earnings applicable to Series 1

$\frac{\$2{,}400}{9{,}335} \times \$282.30 = \$72.58$ Earnings applicable to Series 2

$\frac{\$900}{9{,}335} \times \$282.30 = \$27.22$ Earnings applicable to Series 3

This method considers the division of profits of each year to be final and gives effect to the compounding of such earnings. However, it is not as accurate as Dexter's Method in that it does not use exact time. It is simpler to compute than Dexter's Method.

Theory of Accounts

May 15, 1953, 1:30 to 5 p.m.

No. 1 (12½ points)

a. The debit balance probably arose because the provision for loss is made only at the end of the year but charge-offs are made during the year. At the close of a fiscal year the allowance for doubtful accounts is adjusted to show the estimated loss on receivables which exists at that date. When any of these receivables are determined to be bad, they are written off against this allowance. The bookkeeping routine may call for adding to the allowance only at the year-end, but all accounts which are determined to be bad during a year may be written off as soon as their collectibility is doubtful. Some of the bad accounts may have arisen during the current year and, therefore, the allowance on the books, which was based on the accounts at the end of last year, did not provide for them. This would give rise to a debit balance. To the extent that it arose from charging off the current year's receivables, the debit balance does not indicate that the allowance was inadequate at the close of last year.

b. One method is based upon an aging of the accounts, review of credit information and other criteria of collectibility. This is a direct method of estimating the amount to be set up in the allowance and with experience in a business may be applied with reasonable accuracy. Its principal disadvantages are the amount of work required and the difficulty of predicting whether a given large account will or will not be collected and the fact that it is seldom feasible to apply it monthly.

A variant of the above method is the estimation of the allowance as a percentage of open receivables or as a percentage of past-due accounts with the percentage increasing according to age. If there is a large number of homogeneous accounts which in the aggregate constitute the major portion of the receivables, this method is particularly useful and appropriate.

Another method is the estimation of the bad debt expense as a percentage of net charge sales. The percentage is adjusted from time to time based upon experience. The allowance thus created may be modified at any particular time based upon economic conditions being experienced or in prospect. This method permits monthly charges for the estimated loss, thereby providing a logical basis for relating the charge to income. However, this is an indirect approach and, if used over an extended period of time, may result in an unrealistic allowance. An appraisal of the open balances at the year-end may be made to adjust the allowance to a realistic basis.

c. The classification of bad debt expense as a direct deduction from sales is justified theoretically as a part of the usual rules of revenue recognition. Revenue is recognized when there is a completed transaction such as a bona fide sale. However, the amount of revenue which should be recognized is the cash or the "cash equivalent" received. In the case of a charge sale, the amount of revenue which should be recognized should never exceed the amount of cash which finally will be received. Therefore, all allowances, discounts and uncollectible amounts should be deducted from the gross sales to arrive at the revenue to be reported.

Also the deduction of provision for bad accounts from sales is justified under the usual rule for valuation of assets received as a result of non-cash exchanges. In such an exchange, the fair market value of the asset received is the measure of "cost." Where receivables are taken in exchange for services or goods, the measure of the amounts of the transactions should be the fair market value of the receivables. Under this argument, both receivables and sales should be recorded at the gross amount less estimated returns, allowances and losses. Possibly a deduction should be made also for imputed interest but that is not usually considered in valuing assets.

No. 2 (12½ points)

The theory that depreciation should be based on replacement costs rests on the idea that, to determine the results of a business operation, provision must be made to maintain the purchasing power of the capital invested in it. To accomplish this result the costs of operations are to be charged with depreciation in an amount which will be sufficient to cover the cost of a replacement unit of property when the original unit of property becomes useless. Price levels have been rising for the past twenty years. The owner of a property ordinarily is unable to replace his property for its original cost. For a manufacturing company this would mean that the amount of depreciation charged against income over the useful life of its property is insufficient to replace property as it becomes useless. In order to maintain the productive capacity of a plant it becomes necessary to raise new capital or utilize past earnings to replace useless units of property.

Another argument which has been advanced in favor of basing depreciation on replacement costs is the usefulness of such a charge to management in setting prices, planning expansion, analyzing relative profitableness of different products, etc. Plants built at different times do not show comparable manufacturing costs, even though they are substantially identical plants, if depreciation is based upon historical cost. Management, investors, employees, and frequently government agencies are thereby misled. To these proponents of replacement cost, all computations of cost should be based on current prices of the productive factors utilized in production.

Opponents of the method have several objections to the use of replacement cost in computing depreciation. They point out that this is but one element in costs and that piecemeal adjustment for price level change is not logical. Also they point out that following the policy would not result, except by merest chance, in providing enough depreciation to equal final replacement cost unless the cumulative amount of depreciation is adjusted each year. To follow that procedure involves a basic adjustment of asset values which points up one of the problems involved in bacing depreciation on replacement cost. Also critics state that replacement is seldom with the same kind and type of asset. Some opponents of the proposal argue that the problem of providing for replacement of assets is a financial management problem and not an accounting problem. To many people the most serious objection to the proposal is the lack of objective evidence in most instances as to the current replacement cost of the assets.

No. 3 (12½ points)

1. Cash	$13,200	
Inventory of used equipment (at current used equipment value)	?	
Excess trade-in allowance	?	
Sales		$15,000

The used equipment could be valued at the amount for which it could have been sold in the market for such equipment in its condition at the date of the transaction. There is a secondhand market for many items of equipment, and, where such a market value can be obtained, it should be used in valuing a trade-in. Use of the value separates the sale of the new equipment and enables the business to determine the effectiveness of its handling of used equipment. The excessive allowance should be treated as a reduction of profit on the sale as would be done here.

The equipment would be inventoried in the usual way at balance-sheet date, cost (as established) or market, whichever is lower. Profit on the new equipment would be correctly stated in the current year and the year in which the sale of the used equipment was made would be credited with the profit on it.

2. Cash	$13,200	
Inventory of trade-in merchandise	1,070	
Excess trade-in allowance	730	
Sales		$15,000

This entry is a variant of method (1) which would be used where there is no outside "market" for the used equipment. It records the equipment at a computed market consisting of realizable value less normal profit. The trade-in expense (excess of allowance over inventory value) could be treated as a selling expense or as a sales deduction. The inventory value would be $1,070 unless market had subsequently declined.

This method would provide for the average rate of profit on the used equipment rather than a competitive rate as would be provided by method (1). In both instances there would be a profit in the year in which the used equipment is sold.

3. Cash	$13,200	
Inventory of trade-in merchandise	1,800	
Sales		$15,000

This entry records the sale at list price and the equipment traded in at the allowance granted. It does not take into account that the allowance may be excessive. Accordingly, no loss or expense is recorded with respect to the trade-in as such at the date of trade-in.

This equipment, if unsold and unimproved at the fiscal date, should be valued among the current assets, separately from inventory of new merchandise if the aggregate amount is material, at $1,175 (estimated resale price, less selling expenses of 25 per cent and less $400 estimated reconditioning costs).

This inventory reduction is warranted by the fact that the utility of the goods is less than their recorded "cost." Indeed, it may be argued that their cost is

not $1,800 but $1,175, the difference representing a reduction of sales price or special discount. If the inventory reduction is not made, and if the $625 difference is truly a reduction in sales price, net income for the year of the trade-in will be overstated, and a loss on resale of the equipment in a later period would appear. This would be particularly objectionable if different departments are responsible for the new and used equipment sales. In the reduction to $1,175, the company is assuming that no profit is made on used equipment and is assigning all profit on the series of transactions to the first sale.

4. The same initial entry as in (3) could be made and then the inventory could be written down to $1,070. This would allow the normal profit on the used equipment whenever it is sold.

No. 4 (12½ points)

a. Selling expenses should be excluded from inventory valuation. Inventory cost should be production cost, not the cost of disposing of the product. If the selling expenses were incurred prior to manufacturing the product, there could be justification for deferring the selling expenses but not for merging them with inventory costs.

Costs which are in the nature of "losses" should be excluded from inventory. While idle capacity, spoilage and double handling in small amounts may be considered as inventory costs, because there is always an irreducible minimum of such costs, if they are large in amount or abnormal they should be recognized to be losses and not costs of the goods which were successfully produced.

General and administrative costs should be excluded unless they are related clearly to production. The portion of such costs related solely to factory administration appropriately can be considered as inventory costs.

All nonoperating expenses should be excluded from inventory cost since they are not related to production.

b. The following arguments sometimes are offered as support for the propostion that all fixed overhead should be excluded from inventory costs:

1. Fixed costs are period costs rather than product costs. They occur whether or not there is a large amount or a small amount of production and should be charged to the period in which they occur.

2. There is no satisfactory nor logical method for assigning fixed costs to inventory. Any assignment made will be arbitrary and confusing since such costs are the result of the total productive activity rather than the result of activity aimed at a particular kind or batch of goods. In that sense all fixed costs are "common costs" and not subject to any logical assignment to products.

3. Inclusion of fixed costs is confusing. The lower the volume of production, the higher the apparent unit cost. In the extreme, inventory would have to be adjusted to another basis.

4. No useful purpose is served by charging fixed overhead to production. Information as to variable costs of production is the primary basis of many management decisions. Stockholders, credit grantors and others are informed adequately by statements which exclude fixed overhead from production costs.

The following arguments are offered against the proposition:

1. The proposition does not serve as a practical guide. There is no clear dividing line between fixed and variable costs. Many costs are semivariable. Management intention or the selection of an accounting procedure instead of the nature of the service may be the basis for classifying a cost as fixed or variable. For example, depreciation on a straight-line basis is a fixed cost, whereas depreciation on a unit of output basis is a variable cost.

2. In a manufacturing business all costs are incurred with the expectation of producing and selling goods for an amount which will cover all costs and leave a profit. Costs for the use of plant and equipment and similar "fixed" costs are expected to be recovered in the sales price of products. While fixed costs need not be considered in making certain short-run decisions, they are in no way inferior or subordinate in their nature. Production could not take place without the services represented by fixed costs anymore than without direct labor or material. Any cost which is reasonable and necessary for the production of future revenue should be inventoried in some manner.

3. While there are difficulties in assigning fixed costs to products, a more reasonable value may be obtained by making some assignment than by ignoring the costs entirely.

4. The objection that the inclusion of fixed costs may result in excessive inventory valuation which may have to be adjusted to market is true of all costs under certain conditions. Normally it is not true and the exception can be taken care of. There are methods available for preventing idle plant or unused capacity costs from getting into inventory and these methods do not require the exclusion of all fixed costs from inventory.

5. The "conservatism" resulting from excluding fixed costs from inventory is not an acceptable form of conservatism. It would result in the switching of profit from one period to another and in a continuing understatement of assets on the balance-sheet.

No. 5 (12½ points)

The original creation of this reserve, to the extent of the $10,000 charged against income, was not in accordance with accepted principles of accounting if it was for subsequent price declines and general but unknown contingencies. Such a charge against income resulted in the unjustified reduction in net income for 1950 since no loss had been incurred. The appropriation of $40,000 of retained earnings as a segregation of past earnings because of future possible losses might be considered acceptable as a means of restricting dividend payments, but the appropriation of contributed capital is not acceptable. Except in a formal or informal reorganization, contributed capital cannot properly be charged with losses as is proposed in creation of this reserve.

Therefore, the reserve was created improperly. It is mixed as to source from which it was created, it does not restrict dividend payments except to the extent of the $10,000 which did not go to retained earnings, and it cannot be used as it was used in 1951 by the company.

A reserve created by appropriation of a part of net income or from retained earnings may not be used to relieve the income account of charges which normally should be reflected therein. Therefore, the charges made in 1951 against the reserve should not have been charged to it. The total of $20,000 in the reserve which came from income should not have been direct charges to income but, even if the charges had been made as appropriations of income, none of the three losses should have been charged against it. To permit such treatment results in an overstatement of total earnings since all three of the charges arose in the regular course of business and there is no reason to permit them to bypass the income account. There is no indication that the items are so material as to result in distortion of income if they are charged thereto, and the only one of the three items which could be considered non-operating is the writedown of investments in stock. If it were material that writedown might be to retained earnings, writedown of inventory to market is clearly a current year's cost and loss on accounts receivable is an operating cost.

It must be concluded that no part of the accounting treatment followed by the company is correct or acceptable. The remaining $15,000 in the account should be cleared out. The $40,000 should be restored to premium on common stock and retained earnings should be adjusted as of the end of 1951 if you are making an audit for the year 1952. If management desires to restrict dividend payments by the $15,000, an appropriation of retained earnings can be made.

No. 6 (12½ points)

a. Reduction of the shares from $100 par to $80 par will not result in reducing the excess amount of assets in the business. It will result only in a transfer of $200,000 from the capital stock account to a paid-in surplus account. If the director offering the suggestion had in mind the subsequent distribution to the stockholders of the $20 per share, the objective would be accomplished. While this is a possible procedure, it presents certain legal difficulties.

b. Investing $200,000 in treasury shares would reduce assets and accomplish the general purpose desired. It offers an advantage in that these shares might be resold later if additional capital were needed. However, in some states such a transaction might be illegal in view of the fact that retained earnings are not equal to the $200,000 and in other states it might result in restricting payment of dividends by requiring the retention of $200,000 of retained earnings prior to payment of dividends. In that circumstance, the company would soon find itself back in its present position if earnings continued at present rates.

c. Payment of a $20 per share cash dividend would accomplish the reduction of assets and return the proper amount to the stockholders. However, that procedure would be illegal since it would result in impairment of the "legal capital." Such a distribution could not be called a dividend but would have to be identified as a return of capital. It could be combined with the reduction in the par value proposed in (a) and would be satisfactory, but not as a dividend.

d. Writing down assets by $200,000 would not accomplish the desired result since it would not reduce excess cash nor give the stockholders anything different from what they now have. Neither is the situation one in which a quasi-

reorganization is appropriate. There is no financial difficulty nor evidence of over-valuation of assets which would warrant the application of the "fresh start" premise on which quasi-reorganizations rest.

No. 7 (12½ points)

Other assets:

Cash surrender value of $200,000 officer's life insurance	$54,000	
Prepaid insurance	850	$54,850

Policy	Cash surrender value Dec. 31 1952	1951	Increase in 1952	Premium	Excess of premium over increase	Prepaid at December 31, 1952
1	$32,000	$30,000	$2,000	$2,500	$ 500	$250
3	22,000	19,000	3,000	3,600	600	600
	$54,000	$49,000	$5,000	$6,100	$1,100	$850

The value of policy No. 2 is not included in the balance-sheet because Mr. Jones's wife is sole owner and beneficiary and the company has no right to any of the accumulated value. The entire premium on that policy would be an expense item and ordinarily would all be charged to the year in which payment is made, but three-fourths might be deferred until 1953 if there are facts which indicate that the $1,600 is intended as compensation to Mr. Jones which covers a one-year period from September 30.

The classification of the cash surrender value as noncurrent is based on the presumption that it is not available for use during the next operating cycle and is similar in nature to long-term investments. The $1,100 excess of premiums over increase in cash surrender value would be charged to expense, at least to the extent of $250. The $850 may be considered as deferrable until 1953. A portion of that amount will increase the cash surrender value as time elapses and the remainder will be cost of the coverage obtained. Theoretically only the amount that will increase the cash value should be classified as other assets and the part that represents cost should be shown as prepaid expense. This split cannot be made without having the cash value figure as of the next policy anniversary date.

No. 8 (12½ points)

a. The general fund usually includes accounts for the following:

Cash	Budgetary accounts for:
Taxes receivable	Estimated revenues
Reserve for loss on taxes receivable	Apropriations
Accounts receivable	Encumbrances
Supplies and prepayments	Reserve for encumbrances
Vouchers payable	Expenditures
Due to (or from) other funds	Revenues
Unappropriated surplus	

b. In a municipality most revenues are first accorded some recognition in the budgetary accounts. When the budget is prepared and adopted, estimated revenues are set up by a debit with a corresponding credit to unappropriated surplus.

When taxes are levied and the amount due from each property owner determined, an entry is made debiting taxes receivable, crediting reserve for loss if it is needed, and crediting tax revenue. Revenue recognition is completed at that time, subject to later adjustment for rebates losses and other corrections.

c. The purpose of an encumbrance account is to prevent overexpenditure of appropriations or the incurring of liabilities in excess of available appropriations by making accurate information as to unencumbered balances available. When purchase orders are issued or contracts entered into, an entry is made debiting encumbrances and crediting reserve for encumbrances. The encumbrances together with expenditures made can be deducted from the appropriation to show the amount which is still free. When the purchase is received, the encumbrance entry is reversed and the actual expenditure is recorded.

No. 9 (12½ points)

a. On March 27, 1953, the consignee paid expenses of $24 in connection with the receipt of the consigned merchandise.

On April 25, 1953, the consignee sold the consigned merchandise for $800 cash. The commission of the consignee for the sale was also recorded.

On May 5, 1953, the consignee rendered an account sales and paid the balance due to the consignor.

b.

March 27, 1953

	Debit	Credit
Consignment out	$400	
Inventory		$400

May 5, 1953

	Debit	Credit
Cash	$576	
Expense	24	
Selling commission	200	
Cost of goods sold	400	
Consignment out		$400
Sales		800

ALTERNATIVE ENTRY

May 5, 1953

	Debit	Credit
Cash	$576	
Consignment out		$400
Consignment profit		176

c. The consignment would be reflected on the balance-sheet of the consignee at April 30, 1953, as follows:

Current liabilities:

Due on consignment sales $576

The sale of the consigned goods was made by the consignee as an agent of the consignor. Therefore the sale is not shown in the consignee's income statement. He is entitled to reimbursement for expenses incurred in connection with the consignment and his commission was earned by balance-sheet date.

The consignment would be reflected on the balance-sheet of the consignor at April 30, 1953, as follows:

Current assets:

Due from consignee	$576

The consignor would record the net amount due from the consignee. Presumably this is a current claim and it would be classified as a current receivable.

If the consignor's balance-sheet were prepared before receipt of the account sales, the consignment would be reflected as:

Current assets:

Inventory on consignment	$400

If the consignor did not have knowledge of the sales made he would carry the inventory at his cost. If he knew of the $24 of charges paid by the consignee, it would be shown as a current liability and as an addition to inventory, or as a prepaid expense unless he did not expect the goods to be sold.

No. 10 (12½ points)

The amount of the investment clearly is not material of itself. Any difference between the carrying value of the investment and its "book value," as shown by the subsidary's books, may be shown in the same manner as such difference in any other long-term investment. Therefore, unless there is some relationship in addition to the stock ownership, the procedure recommended by the parent company is acceptable. This clearly would be the case where, for example, (1) the subsidiary has but one class of stock, all of which is held by the parent; (2) the subsidary has no funded debt of any consequence; (3) dealings between the parent and subsidiary have given rise to no significant amount of intercompany receivable or payables; (4) neither the subsidiary nor the parent holds assets acquired from the other, the values of which include substantial amounts of intercompany profits; (5) the subsidiary does not hold shares of the parent; (6) the subsidiary has not been used by the parent in any other way to conduct transactions, the effects of which must be disclosed in order to evaluate properly the parent's financial position and results of operations.

However, if these conditions are not present, consolidation of statements should follow despite the apparent lack of materiality of the parent's investment in its subsidiary. For example, the subsidiary may serve as the principal or sole source of material needed by the parent, or it might be the sales agency for the parent, in which case consolidation of statements is necessary to reflect the operations in the most significant manner.

No. 11 (12½ points)

Since more than 50 per cent of the stock of the corporation is held by less than five individuals, and since income described by the statue as personal holding company income is more than 80 per cent of the gross income of the company, the corporation is a personal holding company and will be liable to the surtax on its Undistributed Subchapter A Net Income.

Consideration should be given to the payment of additional dividends, within the limitations allowed by the provision governing dividend payments after the

close of the year, on or before March 15, 1953.

The company should file a corporation income-tax return and a personal holding company return.

The provision for taxes shown on the income statement was computed as follows:

Net profit before taxes on income	$32,400
Less state taxes on income	1,620
	$30,780
Less dividends received credit—85% of $25,000	21,250
	$ 9,530
Normal tax at	30%
	$ 2,859

Because of the surtax exemption, no surtax is payable. Even if the company were not a personal holding company, it would not be liable for excess-profits tax since the total exclusion of dividends and the minimum credit of $25,000 would leave no income subject to tax.

Auditing

May 14, 1953, 9 a.m. to 12:30 p.m.

(a) No. 1 (12 points)

CORRECTED RECOGNITION

December 31, 1952

Balance per ledger 12/31/52		$17,174.86
Add:		
Outstanding checks		2,467.75
Credit for proceeds of note collected by bank		400.00
		$20,042.61
Deduct:		
Deposits in transit	$2,662.25	
Debit for returned check	200.00	
Bank service charge	5.50	
Error in recording check	178.10	3,045.85
Balance per bank		$16,996.76

(b)

Cash	$400.00	
Notes receivable		$400.00
To record collection of a note left for collection.		
Accounts receivable	200.00	
Cash		200.00
To charge dishonored check to accounts receivable.		
Miscellaneous expense	5.50	
Cash		5.50
To charge December bank service charge to expense.		
Accounts payable	178.10	
Cash		178.10
To charge to accounts payable (or to receivables) the actual amount of a check drawn which was recorded for a lower amount.		

No. 2 (18 points)

It is necessary to give attention to the balance-sheet accounts of a company at the beginning of the year under review in order to establish the accounting principles that have been followed by the company and to ascertain whether or not such principles have been consistently maintained during the period under review. A considerable portion of many of the year-end balances may consist of amounts which were in the opening balances. Consideration of the balance-sheet accounts at the beginning of the year is also important in order to establish that the statement of profit and loss reflects only the results of operations for the current year.

An outline of the principal audit work to be undertaken with respect to balances at the beginning of the year is as follows:

Allowance for Doubtful Accounts

Determine basis for establishing the allowance for bad debts. Determine whether provision made for doubtful accounts at December 31, 1951, is reason-

able in view of aging of accounts receiveable at that date and in the light of subsequent events.

Inventories

1. Review inventory procedures and appraise effectiveness of internal control.
2. Obtain details of inventories at the beginning of the year.
3. Obtain copies of physical inventories instructions for such physicals and discuss manner of taking inventories with plant and other personnel.
4. Review perpetual inventory records to see that adjustments of such records had been made to bring them into agreement with the physical counts and review computation of the dollar adjustment made to the control accounts.
5. Inquire as to provision made for both purchase and sales cut-offs. Test the cut-offs by reviewing shipping and receiving records for several days before and after December 31, 1951, and by checking such items to the general records.
6. Determine the basis of pricing beginning inventories, making tests of such pricing to appropriate records or other documents; obtain market quotations for raw material and supply items and compare with inventory prices. Test also the carrying amount of finished goods with selling price less cost to sell. Inquire also regarding slow moving or obsolete items.
7. Make tests of extensions and footings of beginning inventories and summarize and check to the control accounts.
8. Review statistics pertaining to gross profit ratio for several years prior to the year under review and during the year being examined, and obtain satisfactory explanation for fluctuations.

Fixed Assets and Allowances for Depreciation

1. Prepare or obtain a summary of fixed asset additions from inception of the company to December 31, 1951.
2. Test major additions to invoices, contracts, or other supporting documents to establish the validity of the charges to the fixed asset accounts and to establish the policies with respect to the capitalization of fixed assets. Inquire into procedures with respect to the recording of retirements and make tests of any major retirements as to acceptability of treatment.
3. Review the basis for establishing lives of the equipment and the reasonableness of the accumulated provisions for depreciation.
4. Inquire as to whether physical inventories are taken of fixed assets and whether appraisals have been made for insurance purposes.
5. Establish that all items of equipment are in use and that obsolete items have been adjusted in the accounts. (Include a physical inspection of major property units.)
6 Scan maintenance and repairs account and investigate sufficiently to determine that the account does not include items which should be capitalized under the company policy.

Prepaid Expenses and Deferred Charges

Obtain an analysis of such items as of the beginning of the year. Make such tests as are necessary to establish that the procedures followed by the company in deferring and writing off such items are reasonable.

Payables

Review voucher register and cash disbursements book for a period subsequent to December 31, 1951, to determine whether any material items applicable to the prior period are recorded in the current year.

Accrued Liabilities

1. Obtain an analysis of such items as of December 31, 1951.
2. Inquire into and check basis for setting up such accruals and determine that amounts set up reasonably reflect accrued liabilities as of the beginning of the year.

Reserve for Federal Income Taxes

1. Review the tax returns for all years still subject to examination by the Bureau of Internal Revenue, and reconcile reported taxable income to net income per books.
2. Review revenue agents' reports in several of the preceding years to ascertain whether or not the adjustments reflected therein have an effect on subsequent years.
3. Review computation of Federal income and excess-profits taxes for period referred to in (1) above.
4. Compare balance in the reserve for Federal income tax with amount considered necessary.

Reserves

Obtain an analysis of all reserve accounts at the beginning of the year and ascertain the purpose of such reserves, the manner of making provision to such reserves, and the adequacy of the balance at December 31, 1951.

Stock and Surplus Accounts

An analysis of the capital stock accounts and surplus accounts from inception to date would be necessary.

General

The above program outlines generally the review that should be made as of the beginning of the year of the accounts which are most likely to have a material effect on the reporting of profit and loss and on the year-end balance-sheet. In addition, other historical work, such as a review of minutes of meetings of stockholders, board of directors, etc., would have to be undertaken in order to certify to the financial statements as of December 31, 1952. If long-term liabilities or other major accounts appear on the books and a substantial portion of

them will be carried forward to the closing balance-sheet or affect the operations for the year, they should be examined.

No. 3 (7 points)

The following items of interest and significance to the auditor might be found in a lease:

1. Names and addresses of the parties to the lease.
2. Beginning and ending dates of the lease.
3. Amount of rental and payment dates, including special arrangements such as provisions for graduated rentals, rentals based on gross receipts, etc.
4. Amount of deposit and its ultimate disposition.
5. Description of the property and of the services to be provided by the landlord, such as cleaning or heat.
6. Restrictions on subleasing or other uses of the property.
7. Options to renew the lease or to purchase the property.
8. Condition in which property is to be returned to lessor, including provisions for disposition of leasehold improvements.

No. 4 (8 points)

(*All references are to Rules of Professional Conduct of the American Institute of Accountants.*)

a. Rule 6 states: "A member shall not sign a report purporting to express his opinion as the result of examination of financial statements unless they have been examined by him, a member or an employee of his firm, a member of the Institute, a member of a similar association in a foreign country, or a certified public accountant of a state or territory of the United States or the District of Columbia."

To employ a mailing service as described would be improper in that the accountants would be entrusting a significant phase of the work necessary for them to render an opinion to persons not qualified under Rule 6.

In addition, such action could be in violation of Rule 16 if the client has not given his consent, as the accountants would be in the position of revealing to third parties information relative to their client's affairs.

b. The sending of announcements to clients of his employer or former employer would constitute a violation of Rule 7 which requires that a member "shall not encroach upon the practice of another public accountant." These clients did not seek him out as a practitioner on his own account.

c. The turning over of working papers and business correspondence to a purchaser of a public accounting practice would be proper only if consent of the clients to whom such papers relate has been obtained. Otherwise, the action would be a violation of Rule 16: "A member shall not violate the confidential relationship between himself and his client."

d. Rule 8 says that direct or indirect offer of employment shall not be made by a member to an employee of another public accountant without first informing such accountant.

However, if the prospective employee approached the accountant on his own initiative or in response to a public advertisement, the accountant is free to negotiate with him. Even in such instance, it is good form to inform the applicant's present employer, with the applicant's consent.

No. 5 (10 points)

a. An inventory certificate obtained from a client would include the following kinds of information about inventories:

1. Quantities and amounts
2. Title and ownership
3. Prices and calculations
4. Commitments
5. Condition

b. The signature of an executive may be the only signature. This denotes general approval and acceptance of responsibility for the inventory. Additional signatures relating to quantities, prices, branch inventories, etc., may be attached. These signatures should be made by those who have direct personal knowledge of the information for which they accept responsibility.

c. An inventory certificate is one of the methods by which an auditor obtains information. The importance of inventories suggests the desirability of obtaining written representations instead of oral answers to inquires. Obtaining an inventory certificate does not reduce the responsibility or possible liability of an auditor. However, it does force the client to face up to his responsibility and clearly acknowledge it in writing. This has at least a psychological value.

d. The auditor should first explain to the client that the primary responsibility for the financial statements is the client's. He may point out that basically he is passing on the fairness of the presentation of the client's representations contained in the statements and that it is customary for auditors to obtain explanations and information, both orally and in writing, from the client's personnel as to individual items in the statements. He also may point out that the usual audit is a testing and sampling procedure which cannot cover one hundred per cent of the year's transactions. Also he could point out that commitments and contracts not on the books or otherwise disclosed cannot necessarily be detected by audit procedures, even if extended. The auditor must rely on the client's personnel for much information as to completeness of the records and ordinariiy clients give such information in writing as some assurance to the auditor that he has understood correctly the oral statements received by him.

If the client still refused to sign a representation, the auditor's action would be influenced by many factors. Assuming that there might be material amounts involved, the auditor probably would withhold an over-all opinion as to the statements. Since the representation includes commitments and other items which normal auditing procedure might fail to disclose, it is difficult for the auditor to conclude that there are not any material amounts involved.

No. 6 (15 points)

a. The differences may be the result of any of the following four general types of causes:

1. Differences due to in-transit items, for example: (a) Customers' payments in the mail at the confirmation date and, therefore, recorded on the customers' books but not on the wholesaler's. (b) Billings in the mail to customers at the confirmation date and, therefore, appearing on the wholesaler's books but not on the customers'. (c) Sales returns in transit. (d) Delay in recording collections, credits, etc.

2. Differences due to clerical errors, for example: (a) Postings to incorrect accounts. (b) Errors in taking off account balances.

3. Differences due to fraud, for example: (a) Lapping. (b) Collections not turned in by salesmen or others. (c) Fictitious billings.

4. Differences due to items in dispute, for example: (a) Disputed claims for damaged goods. (b) Disputed discounts taken by customers.

b. Differences should be investigated to determine their causes. This is necessary to disclose any possible fraud or any weaknesses in internal control. If the differences are material, they must be investigated to determine proper statement presentation of the receivables (and related accounts).

In some cases, the public accountant might have the differences investigated by an internal auditor or other employee of the client. The results of the investigation would then be reviewed by the public accountant. In other cases, the public accountant might investigate only enough of the differences as is necessary to establish a pattern. If the remaining differences are immaterial and apparently of the same nature, they need not be investigated but would be referred to the company for explanation. This is particularly true when the differences are due to in-transit items which are correctly reflected on the client's books.

c. As to procedures, an attempt should be made to reconcile the replies with the client's accounts by adjustment for in-transit items. Care must be taken, however, to determine that the in-transit items are valid. "Lapping" or a breakdown in accounting procedures for collections, etc., could be hidden by reconciliations if the validity of the in-transit items were not established.

The clerical accuracy of the client's records should be checked for differences which were not reconciled. A review of correspondence with the customer may reveal disputes and other causes of differences.

To isolate remaining differences, an exchange of detailed account analyses between the client and his customers may be necessary. Correspondence also would be necessary.

d. When a test or sample is relied upon as evidence of the nature of a large group of items, it is essential that the items selected for the sample or test be examined completely. In the case of a test of receivables by the use of positive confirmations, the accounts which do not respond may be non-existent or worthless for some other reason. The exercise of care in sending out the requests, to be certain that those not delivered are returned by the post office direct to the

auditor, helps to eliminate the possibility of fictitious accounts. However, there are remaining dangers as to the "no-reply" accounts.

The auditor can trace the accounts back to shipping tickets, orders or other underlying documents and obtain some evidence as to authenticity. In addition to that procedure, he can provide a responsible company official with a list of the accounts which did not reply and advise him of the circumstances so that the company may take appropriate steps to follow-up these accounts. This notification to the company may be extremely important since it may enable the client to discover irregularities.

No. 7 (12 points)

a. A division of duties among several employees to secure good internal control over incoming mail receipts can be outlined as follows:

1. Someone independent of the accounting or cashier's department opens the mail and lists the receipts together with the names of the remitters. The checks and currency received are then turned over to the cashier and a copy of the remittance list is sent to the accounts receivable bookkeeper and one to the internal auditor.

2. The cashier prepares deposit slips and makes the deposit. If a copy of the remittance list does not serve as the cash receipts book, the cashier will write up the cash receipts book.

3. The accounts receivable bookkeeper posts from the remittance list to the customers' accounts.

4. An internal auditor or other employee will compare the duplicate deposit slips with the original remittance list.

b. In the absence of collusion, the following controls exist:

1. If the person who opens the mail makes an error in listing, it will be discovered by the cashier. If he withholds cash and does not list it, customers' complaints will be received. (The same would be true if the cashier opened the mail.)

2. If the cashier withholds cash, the internal auditor will discover it when comparing duplicate deposit slips with the remittance list. An error in writing up the cash book will throw the trial balance out of balance.

3. The accounts receivable bookkeeper has no oportunity to take the receipts. An error in posting will be shown by comparison of the general ledger control with a trial balance of the accounts receivable.

No. 8 (18 points)

The following adjustments of the Machinery and Equipment account are necessary or suggested by your audit to this point:

1. Freight charges on the purchase of the A24 heavy-duty presses should be capitalized but apparently were not. The invoice shows that the presses were shipped FOB Chicago.

2. Installation costs of the A24 heavy-duty presses should be capitalized but apparently were not. General business knowledge indicates the installation costs would generally be incurred for machines like the A24 press,

3. Machinery should be recorded net of purchase discounts but apparently was not. Credit terms were stated on the invoice to be 2/10; N 30 and the invoice was marked as paid within the discount period.

4. Ordinary repairs or repair parts should not be capitalized but apparently were. Model A21 parts shown on the invoice probably were used to repair an old press or for stock of repair parts.

5. An error in listing or extension appeared on the invoice. Three parts at two dollars each were extended as two dollars. This should be investigated.

6. The credit to the ledger account indicates the retirement and sale of a machine. The source and amount of the entry suggest that the account may have been credited for the amount of cash received instead of the cost of the asset retired. The date of the entry gives further support to this possibility. If further investigation supports these indications, an adjusting entry should be prepared to properly record the retirement.

7. The journal voucher for construction of the conveyor shows no overhead costs. A reasonable allocation of overhead to construction work should be made.

8. The journal voucher for construction of the conveyor shows overtime premiums charged to the conveyor. Ordinarily such premiums should be apportioned between the employees' construction work and other duties. In the case of E. Miller at least, there is an indication that he carried on other work during the construction period. Adjustments should be made as necessary after further investigation.

Commercial Law

May 15, 1953, 9 a.m. to 12:30 p.m.

Group I

No. 1 (10 points)

a. 1. When an agent's duties are routine they normally do not involve the use of discretion and the agent is under a duty to adhere faithfully to his instructions in all cases in which they can be obeyed by the exercise of reasonable and diligent care. (2 American Jurisprudence, Agency, section 277.)

2. When the duties involve employment of discretion, the agent is under a duty to act competently and carefully and, for a mistake in judgment resulting from a failure to have the standard knowledge or to use the standard care, he is subject to liability to the principal. (Restatement of Agency, section 379c, page 840.) However, of course, if as well as having discretionary powers the agent has instructions he must faithfully adhere to such instructions.

b. He is responsible for the principal's entire loss. The funds of the principal should have been kept separate from his own. The nature of his responsibility for not having done so is the same as that of a trustee. (Mechem, Outlines of Agency (3d ed.), page 216; Restatement of Agency, section 398, comment d; 2 American Jurisprudence, Agency, section 284.)

c. The relation of principal and agent may be terminated by the act or agreement of the parties by operation of law.

For example, the principal may revoke the agent's authority and the agent may likewise terminate the agency contract by expressly notifying the other party to this effect. In the absence of statutory restrictions requiring revocation or renunciation to be evidenced in some particular way, it may be either oral or written. The revocation need not be express but may be implied.

An illustration of termination by operation of law is termination as a result of the death of the principal. As a general rule death of the principal operates as a revocation of the agent's authority or power, unless the agency is one coupled with an interest. (2 American Jurisprudence, Agency, sections 35, 40, and 59.)

d. No. Notice of the revocation of the authority of a general agent must be given also to the third parties and as long as they do not have it they are entitled to consider that the agent's authority continues. (Mechem, Outlines of Agency (3d ed.), page 121; 2 American Jurisprudence, Agency, section 44.)

No. 2 (10 points)

a. The term is equivalent to the definition in Black's Law Dictionary for a bona fide purchaser (also called a purchaser for value without notice) as one who buys property of another without notice that some third person has a right to, or interest in, such property, and pays a full and fair price for the same at the time of such purchase, or before he has notice of the claim or interest of such other in the property.

b. 1. Where the seller of goods has a voidable title thereto, but his title has not been avoided at the time of sale, the buyer acquires a good title to the goods, provided he buys them in good faith, for value, and without notice of the seller's defect of title. (Uniform Sales Act, section 24.)

2. Subject to the other provisions of the Uniform Sales Act, where goods are sold by a person who is not the owner thereof, and who does not sell them under the authority or with the consent of the owner, the buyer acquires no better title to the goods than the seller had, unless the owner of the goods is by his conduct precluded from denying the seller's authority to sell. (Uniform Sales Act, section 23, subsection (1).)

c. A negotiable document of title is a document of title in which it is stated that the goods referred to therein will be delivered to the bearer, or to the order of any person named in such document. (Uniform Sales Act, section 27.)

No. 3 (10 points)

a. Section 24 of the Uniform Negotiable Instruments Law states that every negotiable instrument is deemed prima facie to have been issued for a valuable consideration. Section 25 defines value as any consideration sufficient to support a simple contract and provides specifically that an antecedent or pre-existing debt constitutes value.

b. The title of a person who negotiates an instrument is defective within the meaning of the Uniform Negotiable Instruments Law when he obtained the instrument, or any signature thereto, by fraud, duress, or force and fear, or other unlawful means, or for an illegal consideration, or when he negotiates it in breach of faith, or under such circumstances as amount to a fraud. (Uniform Negotiable Instruments Law, section 55.)

c. A real defense means one attaching to the instrument itself and thus good against a holder in due course, as distinguished from a personal defense, which is cut off by a transfer to such a holder.

This distinction was well established at common law but Uniform Negotiable Instruments Law makes no mention of it. Thus in Brannan's Negotiable Instruments Law (5th ed. by Beutel), the author states at page 558:

"*Real Defenses.* At common law the distinction was well established between real or legal defenses, which prevailed against a holder in due course, and personal or equitable defenses, which were cut off by a transfer to such a holder. See 2 Ames, Cases on Bills and Notes, 811, 812. The N. I. L. makes no mention of this distinction. Some former real defenses are covered by specific sections, e.g., forgery by sec. 23, discharge, now a personal defense, cancellation, etc., by sec. 110-123, and alteration by sec. 124, 125. Want of delivery at the inception of the instrument, which was a real defense in some states at common law, has been made an equitable defense by sec. 16 except for incomplete instruments, which fall under sec. 15. But other real defenses are either omitted from consideration or else fall within the terms of sec. 55 and 57 and hence have become equitable defenses under the Act."

No. 4 (10 points)

a. Such factors may be (1) fraud, (2) mistake, (3) duress, (4) undue influence, and (5) misrepresentation. (Clark on Contracts (4th ed.), pages 264-342.)

b. An express contract is one in which the terms of the contract or agreement are openly and fully uttered and avowed at the time of making, being stated in distinct and explicit language, either orally or in writing.

A contract implied in fact is inferred from the facts and circumstances of the case. It is based on consent and is not formally and explicitly stated in words.

With respect to both express contracts and contracts implied in fact there is an actual contract existing between the parties. The difference between them lies in the character of the evidence needed to establish each.

A contract implied in law or quasi-contract is one imposed upon a person by the law, even against his will because the circumstances between the parties are such as to make it just that the one should have a right and the other a corresponding obligation similar to those which would arise from a contract between them. It is an obligation and not a contract. (12 American Jurisprudence, Contracts, section 4; Black's Law Dictionary.)

c. A quasi contract is a contract implied in law; the law, though the defendant did not intend to assume an obligation, imposing an obligation upon him notwithstanding the absence of intention on his part and, in many cases, in spite of his actual dissent. They are founded generally (1) upon a record, (2) upon statutory, official, or customary duties, and (3) upon the doctrine that no one shall be allowed to enrich himself unjustly at the expense of another, with the third class being the most important and most numerous class. (Clark on Contracts (4th ed.), pages 690-718.)

d. An executory contract is one in which some act remains to be done. An executed contract is one in which nothing remains to be done by either party. (Black's Law Dictionary.)

No. 5 (10 points)

a. The most common are that (1) there shall not be too close a resemblance to the name of any other corporation, (2) there must be included in the name a definite indication of corporate character, and (3) there shall not be used by ordinary business corporations any designation which might indicate they have been organized under a special corporation act, as would be the case if such corporations used words like "Bank," "Trust," "Insurance," "Title," or "Mortgage" in their names. (Stevens on Private Corporations, pages 114-120.)

b. "Dummies" are individuals who act as incorporators or directors in connection with the organization of new corporations in the place and on behalf of the true parties in interest. (Stevens on Private Corporations, page 108; Black's Law Dictionary.)

c. A closed corporation is one whose stock is closely held by a limited number of persons. (Brooks v. Willcuts, 78 F.2d 270, at 273 (8th Cir. 1935).)

d. No. A corporation cannot in any proper sense be one of its own stockholders. (Fletcher, Cyclopedia Private Corporations, Vol. 5 (1952 replacement volume), section 2041.)

Group II

No. 6 (10 points)

a. The partnership can recover $5,625. The partnership did not insure its building up to 80% of the value of the building at the time of the loss, and, to the extent that the partnership failed to do so, the partnership shares in such loss. The policy was for $12,000 instead of $12,800 which would have been 80% of $16,000.

$$\frac{\$12{,}000 \text{ (policy)}}{80\% \text{ of } \$16{,}000} \times \$6{,}000 \text{ (loss)} = \$5{,}625 \text{ (recovery)}$$

(Vance on Insurance (3d ed.), page 887; 45 Corpus Juris Secundum, Insurance, pages 1020-21.)

b. Yes. The partnership had an insurable interest in the life of each of its partners at the time the policy was issued, inasmuch as the parternship would benefit from the continued existence, and suffer loss by the death, of a partner. Although the person procuring life insurance is required to have an insurable interest in the life of the person insured at the time of the issuance of such insurance, he is not required to have such insurable interest at the time of the death of the insured. (Vance on Insurance (3d ed.), pages 183, 197, 198; 29 American Jurisprudence, Insurance, pages 311, 324.)

No. 7 (10 points)

a. 1. Three entities which cannot become voluntary bankrupts are municipal, railroad, or insurance corporations. (U. S. Code Annotated, Title 11 (Bankruptcy), section 22a.)

2. Two entities, not mentioned above, which cannot be adjudicated involuntary bankrupts are banking corporations and building and loan associations. (U. S. Code Annotated, Title 11 (Bankruptcy), section 22b.)

b. $1,000. No person can be forced into bankruptcy unless his liabilities equal at least $1,000. (U. S. Code Annotated, Title 11 (Bankruptcy), section 22.)

c. A petition to have a person adjudged a bankrupt may be filed by three or more creditors who have provable claims. These claims must be fixed as to liability and liquidated as to amount and must total in the aggregate $500 or more, in excess of the value of securities held by them. However, if all the creditors of such person are less than twelve in number, then one or more of such creditors whose claims meet the above tests may file such a petition. (U. S. Code Annotated, Title 11 (Bankruptcy), section 95b.)

d. The bankrupt is allowed the exemptions prescribed (1) by the laws of the United States, or (2) by the law of the state wherein he was domiciled for the six months immediately preceding the filing of the petition, or for a longer portion of such six months than in any other state. However, the bankruptcy law provides that no exemption shall be allowed out of property transferred or concealed by a bankrupt and which is recovered or the transfer of which is avoided for the benefit of the estate, except that where the voided transfer was made by way of security only and the property recovered exceeds the amount secured thereby such allowance may be made out of such excess. (U. S. Code Annotated, Title 11 (Bankruptcy), section 24.)

No. 8 (10 points)

a. The contributions of a limited partner may be by cash or other property, but not services. (Uniform Limited Partnership Act, section 4.)

b. Yes. A person may be a general partner and a limited partner in the same partnership at the same time. A person who is a general partner, and also at the same time a limited partner, shall have all the rights and powers and be subject to all the restrictions of a general partner; except that, in respect to his contributions, he shall have the rights against the other members which he would have had if he were not also a general partner. (Uniform Limited Partnership Act, section 12.)

c. No. A limited partnership is a partnership formed by two or more persons, having as members one or more general partners and one or more limited partners. In every limited partnership there must be at least one general partner who is personally liable to firm creditors, since the limited partners have no liability beyond their original capital contributions so long as they take no part in the management. (Uniform Limited Partnership Act, sections 1, 7.)

d. Yes. In general a limited partnership may carry on any business which a partnership without limited partners may carry on, except those forms of business the practice of which is prohibited by the Uniform Limited Partnership Act of the particular state. (Uniform Limited Partnership Act, section 3.)

No. 9 (10 points)

a. Yes. A minor is generally a person under the age of 21, sometimes 18 in the case of females. A minor's contract relating to personal property (not falling in the category of necessaries) can be rescinded by the minor at any time before he attains his majority and for a reasonable time thereafter. When the infant is guilty of actual misrepresentation, as in the instant case the generally accepted view is that apart from statute he is not precluded from asserting his privilege as an infant with its ordinary consequences. Also the weight of authority appears to support the view that the infant vendee may recover the price paid merely upon offering to return the property, if any, remaining in his hands, without accounting to the vendor for depreciation or damage to the property. This appears to be true even in a case where the infant has squandered, wasted, disposed of, or consumed the property purchased by him.

In a few states statutory law bars rescission where the minor misrepresents his age.

Also, in some jurisdiction, although the seller would be liable to refund to the minor the downpayment, the minor in turn would be liable to the seller for deceit for the damages sustained by the seller as a result of the deceit. The measure of such damages would appear to be the damage to the radio. (Williston on Contracts (Rev. ed.), sections 224, 226, 235, 238, 245; 27 American Jurisprudence, Infants, page 780; Clark on Contracts (4th ed.), pages 204, 219, 242.)

b. Yes. The infant misrepresented his age. A transaction induced by fraud is voidable by the defrauded person and it is immaterial for this purpose whether the fraudulent person is an infant or an adult. (Williston on Contracts (Rev. ed.), section 245; 27 American Jurisprudence, Infants, section 63.)

c. No. A parent of a minor is not liable on the minor's contract merely because he is the parent. Except in certain cases involving necessaries, a parent of a minor is not liable on the minor's contract merely because he is a parent. (Williston on Contracts (Rev. ed.), section 247.)

No. 10 (10 points)

Since the fire was through no fault of Y, Y is not liable to X for the loss of the furniture.

When Y first received X's furniture he held it as a common carrier awaiting available van space. He was, therefore, holding the furniture for his own convenience and not the convenience of X. However, when X telephoned Y and instructed Y not to ship to Chicago but to hold the furniture for further instruction, Y then held the furniture as a warehouseman or bailee. Since the fire occurred while Y was holding X's furniture in this latter capacity, Y was liable, if at all, as a warehouseman or bailee. Since a warehouseman or bailee is not an insurer of the goods in his possession, but is only liable for his negligence, Y is not liable for the loss inasmuch as the fire was attributable to no fault of Y's. (Bell v. Fitz, 78 Ga. App. 28, 50 S.E. 2d 241 (1948); Uniform Warehouse Receipts Act (as amended), section 21; Brown on Personal Property, section 99.)

No. 11 (10 points)

1. False. (Uniform Sales Act, section 12.)
2. False. (Uniform Sales Act, section 12.)
3. False. The agreement is void, not merely voidable. (Uniform Sales Act, section 7, subsection (1).)
4. True. (Uniform Sales Act, section 16, subsection (a).)
5. False. (Uniform Sales Act, section 37.)
6. True. (Uniform Sales Act, section 54, subsection (1) (a).)
7. True. (Uniform Conditional Sales Act, section 2.)
8. False. (Uniform Conditional Sales Act, section 17.)
9. False. (Uniform Conditional Sales Act, sections 17 and 18.)
10. True. (Uniform Conditional Sales Act, section 27.)

No. 12 (10 points)

1. True. However, as contracts of an infant and conveyances by an infant are voidable, he cannot properly administer a trust. An infant trustee will normally be removed by the court, at least until he become sof age. (Restatement, Trusts, sec. 91; 54 American Jurisprudence, Trusts, sec. 115.)
2. False. (Restatement, Trusts, sec. 101; Scott on Trusts, sec. 101.)
3. False. (Restatement, Trusts, sec. 106; Scott on Trusts, sec. 106.)
4. False. (Restatement, Trusts, sec. 194 Comment e; Scott on Trusts, sec. 194.)
5. True. (Restatement, Trusts, sec. 192; Scott on Trusts, sec. 192.)
6. False. (Restatement, Trusts, sec. 233 Comment e; Scott on Trusts, sec. 233.2.)
7. False. (Restatement, Trusts, sec. 233 Comment f; Scott on Trusts, sec. 233.3.)

8. False. (Uniform Principal and Income Act, sec. 5, subsection (1).)
9. True. (Uniform Principal and Income Act, sec. 10.)
10. True. (Uniform Principal and Income Act, sec. 12, subsection (4).)

Examination Answers, November, 1953

Accounting Practice—Part I

November 4, 1953; 1:30 to 6 p.m.

No. 1 (15 points) (Required)

Part a. Place an X in the correct column for each of the 20 numbered questions.

	Effect on Profits		
Number	*Overstated*	*Understated*	*No effect*
1	X		
2		X	
3			X
4	X		
5		X	
6	X		
7			X
8		X	
9	X		
10			X
11		X	
12	X		
13		X	
14		X	
15	X		
16			X
17	X		
18		X	
19		X	
20	X		

Part b. State whether the change resulted in a *decrease,* in an *increase* or in *ro effect on the reported profits.*

No.	*Answer*
1	Decrease
2	Decrease
3	Increase

Part c. Enter the net amount of the adjustment necessary.

	Net Effect on 1951 Profit	
Item	*Increase*	*Decrease*
A		$ 744
B		200
C	$ 308	
D		610
E	2,610	
F		
G	30	
H		1,500
Total	$2,948	$3,054
		2,948
Net		$ 106

Part d. Enter the letter (a, b, c or d) which identifies your answer.

No.	*Answer*
1	b.
2	b.
3	b.
4	d.

A, B AND C (A PARTNERSHIP)

Statement of Inventory

At January 2, 1953

			CLASS Z			CLASS Z—FINISHED		
		Class X & Y	*Raw Material*	*Material*	*Labor*	*Overhead*	*Total*
Inventory Jan. 1, 1950		$ 86,580	$17,550	$ 9,360	$ 4,680	$ 2,340	
Less 17% handling, etc.		12,580	2,550	1,360	680	340	
		$ 74,000	$15,000	$ 8,000	$ 4,000	$ 2,000	
Add 2% handling		1,480	300	160			
Adjusted inventory Jan. 1, 1950		$ 75,480	$15,300	$ 8,160	$ 4,000	$ 2,000	
Purchases of materials—Exhibit B		240,434	33,000				
Handling 2%		4,809	660				
Class Z raw material put into process—plus 2%			(34,680)	34,680			
Labor and overhead					17,000	8,500	
Total		$320,723	$14,280	$42,840	$21,000	$10,500	$74,340
Cost of goods sold:							
Class X—Exhibit C	$126,158						
Class Y—Exhibit C	68,841	194,999					
Class Z—Exhibit C							71,365
Inventory Jan. 2, 1953		$125,724	$14,280				$ 2,975

Inventory Jan. 2, 1953:	
Merchandise, Classes X & Y	$125,724
Finished goods, Class Z	2,975
Raw material, Class Z	14,280
	$142,979

A, B AND C (A PARTNERSHIP)

Statement of Purchases

EXHIBIT B

For the Years 1950, 1951 and 1952

		Purchases Per Adding Mach. Lists	*Cr. Memos. Listed as Invoices*	*Additional Cr. Memos.*
Year 1950		$131,616	$ 7,548	$ 1,751
Year 1951		117,935	7,225	3,128
Year 1952		76,158	6,120	5,610
Totals		$325,709	$20,893	$10,489
Deductions:				
Credit memos listed as invoices 2 × $20,893	$41,786			
Additional credit memos	10,489	52,275		
Net purchases		$273,434		

EXHIBIT C **Statement of Sales and Cost of Goods Sold**

For the Years 1950, 1951 and 1952

	Sales	*Cr. Memos.*
Year 1950	$122,785	$ 6,585
Year 1951	110,942	7,582
Year 1952	96,100	4,160
Total	$329,827	$18,327
Deduct credit memos	18,327	
Net sales	$311,500	

	Net Sales		*Cost of Goods Sold*	
	Per cent	*Amount*	*Per cent of Sales*	*Amount*
Net sales by products:				
Class X	45	$140,175	90	$126,158
Class Y	26	80,990	85	68,841
Class Z	29	90,335	79	71,365
		$311,500		$266,364

No. 3 (10 points) (Optional)

SIMS AND COMPANY

Schedule of Cash Distributions to Partners

1953

Partner's Account	*February Distribution*	*March Distribution*
Quinn—Loan	$ 2,660	$ 2,340
Quinn—Capital		608
Rowe—Capital	16,590	4,422
Sims—Capital	20,770	4,422
Toth—Capital		1,858
Total	$40,020	$13,650

Computation of Cash Distribution

	Cash	*Non-Cash Assets*	*Accounts Payable*	*Quinn Loan*	*Quinn Capital*	*Rowe Capital*	*Sims Capital*	*Toth Capital*
Balances 2/1/53	$33,440	$64,510	$7,120	$5,000	$8,040	$32,160	$36,340	$9,290
Cash from sale of assets	16,440	(16,440)						
Loss and expenses of realization	(2,740)	(5,580)			(1,664)	(2,496)	(2,496)	(1,664)
Payment to creditors	(5,910)		(5,910)					
Adjustment for possible loss of non-cash assets		(42,490)			(8,498)	(12,747)	(12,747)	(8,498)
Adjustment for possible capital deficiency of Quinn				(2,122)	2,122			
Adjustment for possible capital deficiency of Toth				(218)		(327)	(327)	872
Adjusted balances 2/28/53	$41,230		$1,210	$2,660		$16,590	$20,770	
Cash distribution	(40,020)			(2,660)		(16,590)	(20,770)	

Add non-cash assets and adjustment for deficiency		$42,490		2,340	$6,376	13,074	13,074	$7,626
Balances 3/1/53 ..	$ 1,210	$42,490	$1,210	$2,340	$6,376	$13,074	$13,074	$7,626
Cash from sale of assets	16,110	(16,110)						
Expenses less gain..	(2,460)	1,160			(260)	(390)	(390)	(260)
Adjustment for possible loss of non-cash assets		(27,540)			5,508	8,262	8,262	5,508
Payment to creditors	(1,210)		(1,210)					
Adjusted balances 3/31/53	$13,650			$2,340	$ 608	$ 4,422	$ 4,422	$1,858
Cash distribution...	(13,650)			(2,340)	(608)	(4,422)	(4,422)	(1,858)

No. 4 (10 points) (Optional)

HOWLE MANUFACTURING CORPORATION

Computation of Unit Sales Price

	1953 Actual 1952	*Budgeted Changes*	*Budgeted 1953*
Costs and expenses:			
Budgeted profit	$ 40,500		$ 60,000
Materials	153,000	× 130% × 120%	238,680
Direct labor	102,000	× 130% × 115%	152,490
Indirect manufacturing costs.......	51,000	× 130% × 110%	72,930
Selling expenses	60,000	× 114%	68,400
Administrative expenses	30,000	× 107%	32,100
Sales dollars needed to cover profit and all costs other than returns, allowances and discounts			$624,600

Returns, etc., are 3% of sales price; therefore $624,600 = 97% of Gross Sales needed for the year.

Sales should be $624,600 ÷ by .97 or $643,918.

$643,918 (sales dollars necessary) ÷ by 39,000 units (budgeted volume) = $16.51 required sales price per unit.

Alternate Computation of Sales Price

Net budgeted sales at present price—$436,500 × 1.30 = $567,450
Net at old price of $567,450 ÷ by sales needed of $624,600 = .9085
Sales price of $15.00 = 90.85%
100% = $16.51

No. 5 (10 points) (Optional)

TOWN OF W

Balance-Sheets

June 30, 1953

General Fund

Cash	$ 15,000	Accounts payable	$ 10,000
Taxes receivable	20,000	Unappropriated surplus	35,000
Supply inventories	10,000		
	$ 45,000		$ 45,000

Special Assessment Fund

Taxes receivable	$ 80,000	Bonds payable	$ 75,000
		Balance	5,000
	$ 80,000		$ 80,000

Trust Fund

Cash	$ 10,000	Balance	$ 40,000
Investments	30,000		
	$ 40,000		$ 40,000

Bond Fund

Cash	$ 25,000	Balance	$ 25,000
	$ 25,000		$ 25,000

General Fixed Assets

Land	$100,000	Investment in fixed assets	$950,000
Buildings	800,000		
Equipment	50,000		
	$950,000		$950,000

General Bonded Debt

Amount to be raised by future taxation	$350,000	Bonds payable	$350,000
	$350,000		$350,000

TOWN OF W

Balance-Sheet—General Fund

July 31, 1953

ASSETS

Cash			$ 6,176
Taxes receivable			17,350
Estimated revenue		$233,000	
Less Revenues		2,060	230,940
Supply inventories			10,400
			$264,866

LIABILITIES AND SURPLUS

Accounts payable			$ 4,263
Appropriations		$235,000	
Less—Expenditures	$7,863		
Encumbrances	6,250	14,113	220,887
Reserve for encumbrances			6,250
Unappropriated surplus			33,466
			$264,866

Accounting Practice—Part II

November 5, 1953; 1:30 to 6 p.m.

No. 1 (12 points)

a.
1. False. Distributable trust income consisting of municipal interest is tax-free to the beneficiary.
2. False.
3. False.
4. False. The distribution was taxable to the extent of the earnings and profits for the year—$50,000.
5. False.
6. True. Ordinary income because cattle must be held for at least twelve months to constitute capital gain.
7. False. Taxable income is realized under the *Jacobson* case.
8. True. Excluded under the tax benefit rule and Section 22(b)(12) IRC.
9. True.
10. True. Provided that taxpayer has owned such timber or has had a contract right to cut the timber for a period of more than 6 months prior to 1952.
11. False. No gain recognized on a trade-in.
12. False. The profit attributable to the unharvested crop is a long-term capital gain.

b.
1. False. No write-down to market is permissible when LIFO has been elected.
2. False. A reserve for discounts is not deductible.
3. False. A sale of property used in a trade or business at a loss is an ordinary loss.
4. False. The taxpayer may elect to have the amortization period commence with either the month or the year following acquisition, but in either event the allowable amortization for 1953 would not be $6,500.
5. False. Only $5,000 is deductible since any additional amount allowable was paid subsequent to sixty days following the close of the year.
6. False. His post of duty (Washington, D. C.) is his home.
7. False. Fees paid in connection with drawing wills are not deductible.
8. False. Interest paid to carry tax-free income is not deductible (Regulations Section 29.23(b)-1.)
9. False. Cost depletion of $20,000 is allowable since percentage depletion is limited to 50% of net income (before depletion) from the property.
10. False. Canadian income tax may be deducted as a tax under Section 23(c) or may be claimed as a foreign tax credit under Section 131.
11. False. Fines paid are not deductible.
12. False. A deduction for casualty loss is limited to the taxpayer's basis of $3,000.

No. 2 (8 points)

PITTS-MARVEL SALES CORPORATION
Adjusting Entries
December 31, 1952

(1)

Unrealized gross profit—1950	$ 8,407.00	
Unrealized gross profit—1951	93,438.80	
Unrealized gross profit—1952	71,006.70	
Realized gross profit		$172,852.50

To record realization of portions of gross profit in the present year of collection:

Sales Year	*Collections*	*GP Rate*	*Realized GP*
1950	$ 24,020	35%	$ 8,407.00
1951	274,820	34%	93,438.80
1952	191,910	37%	71,006.70

Computation of collections:
1950: 1/1/52 balance of receivables collected in full in 1952 = $24,020.
1951: $344,460 (balance 1/1/52)—$67,440 (balance 12/31/52)—$2,200 (amount of default) = $274,820.
1952: Sales $602,000—$410,090 (balance uncollected 12/31/52) = $191,910.

(2)

Unrealized gross profit—1951	$748.00	
Inventory of repossessed merchandise		$748.00

To write off portion of 1951 unrealized gross profit lost ($2,200 uncollected balance × 34% GP rate = $748) and to reduce inventory to cost as measured by the net amount of the receivable.

The inventory might be reduced to a "computed market" by the following entry:

Loss on repossession	$381.00	
Inventory of repossessed merchandise		$381.00

To write the inventory down to market computed as follows:

Sale value	$1,700
Gross profit rate (1952)	37%
Computed market (63% of $1,700)	$1,071
Adjusted book basis	1,452
Adjustment	381

b. Inventory is sometimes valued "at cost," sometimes "at market," but most frequently at cost or market, whichever is lower.

There is some question as to what is "cost" in the case of repossessed merchandise. In the solution proposed in (a), cost was assumed to be the net amount at which the receivable was carried on the company's books. However, cost might be considered to be the unrecovered amount of the original cost. That assumption would require an additional reduction of $1,088 (34% of the $3,200 collected) leaving the inventory on the books at $364. There are objections to such a valuation. It might produce a negative value, or a zero value, or an unrealistically low value such as in the present case. Also it does not take account of expenses incurred by the company in making the sale or carrying the account. Use of it in effect reverses the entry made in the prior year when some gross profit was taken

into income. However, neither does the use of net amount of the receivable as "cost" take account of expenses of making the sale and it also may be unrealistic in specific cases.

Use of the gross receivable, $2,200, as cost can be considered but is open to the serious objection that it involves recognition of a profit in the period in which profit has proven to be unrealizable. It is not consistent with the installment method in use by the company and seems to have little basis for being considered cost.

In part because of the difficulties involved in using cost as a basis for valuing repossessed goods, many businesses favor the valuation of repossessions at market. The advantage of valuation at market is that it permits a reasonable determination of the gain or loss resulting from the repossession of the goods and ordinarily produces a value that permits a normal profit on the resale of the items. Market, in the usual case, would be the price at which an item could be purchased for cash. However, for certain repossessed items, there might be no established market price. Also, market might change between the date of repossession and the statement date. The $1,700 resale price is not market in the sense that it is used in inventory valuation and, therefore, should not be used to value the inventory.

However, in cases where there is no market in the usual sense, a market may be computed and either used alone or be used under the cost or market rule. Computation of market would start with the resale price ($1,700) and deduct expenses of disposal and normal profit margin to give a computed market.

In the use of cost or market, whichever is lower, we have a limitation on the preceding definition of market as follows: Market should not exceed the net realizable value nor should it be less than net realizable value reduced by an allowance for an approximately normal profit margin. These rules would be applicable if there were an existing market for the items.

No. 3 (30 points)

RICHARDSON'S CHEMIX, INC.
Balance-Sheet Work Sheet
December 31, 1952

	Balance Per Books 12/31/52		*Audit Adjustments*		*Balance-Sheet 12/31/52*	
Account	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash	$113,690				$113,960	
Accounts receivable —trade	104,800			(16)$ 9,000	95,800	
Accounts receivable —containers			(16)$ 9,000		9,000	
Estimated uncollectible accounts		$ 3,400		(11) 100		$ 3,5
Finished product inventory	152,000			(14) 2,900	149,100	
Raw material inventory	66,000		(13) 10,100		76,100	
Miscellaneous materials inventory	19,025				19,025	
Returnable containers	16,560		(7) 1,440	(8) 4,860	13,140	

Prepaid insurance	2,400				2,400	
Cash value of life insurance	3,900				3,900	
NAR Distributors, Inc. stock	25,000			(17) 2,000	23,000	
Land	10,000				10,000	
Building	220,000				220,000	
Accumulated depreciation—building		28,300				28,300
Machinery and equipment	77,500		(3) 40,000		117,500	
Accumulated depreciation — machinery and equipment		43,050		(5) 800		43,850
Vouchers payable		49,575				49,575
Accrued interest payable			(2) 2,500	(1) 2,500		
Withheld and accrued taxes		17,020	(6) 6,300			10,720
Federal income tax payable		48,370		(18) 4,750		53,120
Estimated liability for container refunds				(10) 2,700		2,700
Equipment contract payable — current portion				(3) 30,000		30,000
Equipment contract payable — long-term				(3) 10,000		10,000
Mortgage bonds payable		197,760		(1) 2,240		200,000
Unamortized bond discount and expense			(1) 4,680		4,680	
Capital stock (stated value $50)		75,000				75,000
Paid-in surplus		46,920		(4) 25,100		72,020
Retained earnings		251,150	(17) 2,000			
			(4) 25,100			224,050
Treasury stock	4,710				4,710	
Net income after taxes		55,310		4,170		59,480
	$815,855	$815,855	$101,120	$101,120	$862,315	$862,315

RICHARDSON'S CHEMIX, INC.
Income Statement Work Sheet
Year Ended December 31, 1952

Account	Per Books 12/31/52 Debit	Per Books 12/31/52 Credit	Audit Adjustments Debit	Audit Adjustments Credit	Income Statement 1952 Debit	Income Statement 1952 Credit
Sales		$1,615,000	(10)$ 9,000			$1,606,000
Cost of sales	$1,017,515		(12) 11,025	(7)$ 1,440		
			(14) 2,900	(9) 6,000		
				(13) 10,000		
				(15) 27,450	$ 986,450	
Processing costs applied		357,000	(15) 27,450			329,550
Processing costs	329,875		(5) 800	(12) 11,025	329,550	
			(6) 9,900			
Selling and distribution expense	305,525		(6) 8,100	(10) 6,300		
			(8) 4,860			
			(9) 6,000		318,185	
General and administrative expense	210,375		(11) 100	(6) 24,300	186,175	
Other additions and deductions	5,000		(1) 60	(2) 2,500	2,560	
Subtotals					$1,822,920	$1,935,550
Federal income tax	48,400		(18) 4,750		53,150	
Net income after taxes	55,310		4,170		59,480	
	$1,972,000	$1,972,000	$89,115	$89,115	$1,935,550	$1,935,550

Audit Adjustments

	Debit	Credit
(1) Other additions and deductions (amortization of bond discount and expense)	$ 60	
Unamortized bond discount and expense	4,680	
Mortgage bonds payable		$ 2,240
Accrued interest payable		2,500
To correct entry for sale of bonds and record amortization of bond discount and expense; increase bond liability to face, set up 234 mos. unamortized discount and expense; record interest accrued to date of sale		
(2) Accrued interest payable	2,500	
Other additions and deductions (interest)		2,500
To reclassify portion of interest charge set up in JE 8.		
(3) Machinery and equipment	40,000	
Equipment contract payable—current portion		30,000
Equipment contract payable—long-term		10,000
To set up unrecorded balance of cost of and liability for machinery. (see JE 8)		
(4) Retained earnings	25,100	
Paid-in surplus		25,100
To transfer to paid-in surplus $100 excess of re-sale price of treasury stock over cost, incorrectly credited to Retained earnings (JE 12), and $25,000 excess of dividend declaration over stated value of stock dividend (JE 13).		
(5) Processing costs	800	
Accumulated depreciation—machinery and equipment		800
To correct depreciation charge on new equipment purchased in November (JE 8), recorded by client as $250 (2 mos. @ 12% on $12,500); should be $1,050 (2 mos. @ 12% on $52,500).		

	Debit	Credit
(6) Withheld and accrued taxes	$ 6,300	
Processing costs	9,900	
Selling and distribution expense	8,100	
General and administrative expense		$24,300

To reduce accrual of employer's share of payroll taxes by 4½% of exempt payroll of $140,000 on which accrual was incorrectly recorded (JE 16), and to reclassify expense as follows:

	Processing	*Selling*	*General*	*Liability*
Gross payroll	$250,000	$250,000	$100,000	
Exempt payroll	30,000	70,000	40,000	
Taxable payroll	$220,000	$180,000	$ 60,000	
Tax @ 4½%	$ 9,900	$ 8,100	$ 2,700	$20,700
Per books—client's JE 16	—	—	27,000	(27,000)
Adjustment required	$ 9,900	$ 8,100	$(24,300)	$ 6,300

	Debit	Credit
(7) Returnable containers	1,440	
Cost of sales		1,440

To reverse client's adjustment (JE 17). See next entry for adjustment to inventory.

	Debit	Credit
(8) Selling and distribution expense	4,860	
Returnable containers		4,860

To write down inventory to physical and to charge expense for losses and use:

Location	*Amortized unit cost*	*Amortized cost*	*Per books (After Adj. 7*
Plant—60 (lost)	—	—	$ 360
940 (new)	$6.00	$ 5,640	5,640
2000 (50% used)	3.00	6,000	12,000
Customers—300 (1/6 used)	5.00	1,500	—
		$13,140	$18,000

	Debit	Credit
(9) Selling and distribution expense	6,000	
Cost of sales		6,000
To reclassify net charge to cost of sales (JE 2 and 4) for 1000 not returned.		
(10) Sales	$ 9,000	
Estimated liability for container refunds		$ 2,700
Selling and distribution expense		6,300
To reclassify net credit to sales for 1000 containers, setting up estimated liability for 300 good containers in hands of customers and crediting selling expense for "sale" of 700 containers.		
(11) General and administrative expense	100	
Estimated uncollectible accounts		100
To increase reserve to $3,500 estimated uncollectible.		
(12) Cost of sales	11,025	
Processing costs		11,025
To transfer inventory adjustment (JE 18) for miscellaneous materials to processing costs.		
(13) Raw materials inventory	10,100	
Cost of sales		10,100
To set up inventory in transit. Liability was recorded with charge to cost of sales (JE 20).		

		Dr.	Cr.
(14) Cost of sales		2,900	
Finished product inventory			2,900
To adjust inventory to a value of $1.491 per lb:			
100,000 lbs. @ $1.491	$149,100		
Balance per books	152,000		
Adjustment	$ 2,900		
Computation of unit cost:			
Av. cost of material issued per inventory records	$1.020		
Actual processing costs: $329,550 divided by 700,000 lbs. *produced* in 1951	.471		
	1.491		
(15) Processing cost applied		$27,450	
Cost of sales			$27,450
To adjust to actual cost and to relieve cost of sales of over-applied processing costs.			
(16) Accounts receivable—containers		9,000	
Accounts receivable—trade			9,000
To reclassify.			
(17) Retained earnings		2,000	
NAR Distributors, Inc. stock			2,000
To reverse JE 21.			
(18) Federal income tax		4,750	
Federal income tax payable			4,750
To adjust tax:			
Net income—w/s sub-totals	$ 112,630		
Add—life insurance premium charged to expense	100		
	$ 112,730		
Combined normal tax and surtax, 52% of $112,730	$58,619.60		
Less	5,500.00		
Total tax	$53,119.60		
Liability balance per books	48,370.00		
Adjustment	$ 4,749.60		

Theory of Accounts

November 6, 1953; 1:30 to 5 p.m.

Group I

No. 1 (20 points)

1. a.

Net asset	$9,400	
Depreciation allowance—old asset	5,000	
Old asset		$8,000
Cash		5,800
Gain on disposal of old asset		600

b. This entry reflects the view that the best measure of the cost of the new asset is the market value of the old asset plus the cash payment. Stated another way, this entry reflects the view that the gain or loss on disposal of the old asset is best indicated by the market value of the old asset. This view is reasonable when there is a customary discount on the new asset and there is an established market price for the old asset and when a gain or loss on disposal of the old asset is indicated.

2. a.

New asset	$10,000	
Depreciation allowance—old asset	5,000	
Old asset		$8,000
Cash		5,800
Gain on disposal of old asset		1,200

b. This entry reflects the view that the cost of acquiring the new asset is the list price of the asset. This view is reasonable when there is seldom a discount on the new asset and no standard market price for the old asset. Its validity is strengthened when a gain on disposal of the old asset is indicated by a rising price level or other evidence.

3. a.

New asset	$8,800	
Depreciation allowance—old asset	5,000	
Old asset		$8,000
Cash		5,800

b. This entry reflects the view that the cost of acquiring the new asset is the cost of the payment made for it. Therefore, the unamortized balance of the cost of the old asset plus cash constitutes the cost of the new asset. This view is reasonable when there is no customary market price for either the new asset or the old asset and when there has been no marked change in the price level. It would not be appropriate in a situation such as is set forth in the question. It might be used where the difference is not material and it is desirable to keep the accounting records on the income-tax basis.

4. a.

New asset (at net cash price)	$x,xxx	
Depreciation allowance—old asset	5,000	
Old asset		$8,000
Cash		5,800
Gain on disposal of old asset		xxx

b. This entry might be appropriate where there is regularly a discount available on the cash purchase of the new asset and it differs from the total of the cash and market value of the old asset. It accepts the theory that the cost of an asset should be measured by its net cash price.

No. 2 (20 points)

	Unrelated Companies		
	X	*Y*	*Consolidated*
Item A.			
Corporation X values its inventory at the manufacturing cost of $20.00 which is lower than either its sales price to Y of $25.00 or to others @ $40.00.	$200.00		
Corporation Y values its inventory at its purchase cost of $25.00 from Corporation X which is lower than its sale price to others of $40.00. Storage expense generally is not added to the inventory valuation of goods purchased for resale without further processing. However, in some instances storage costs may be a necessary element of cost of acquisition; for example, when it is necessary to purchase in quantities well beyond current needs in order to insure against shortages. In cuch cases storage costs might appropriately be included in cost of inventory.		$250.00	
The consolidated inventory price is the cost of manufacturing to X. The intercompany differential of $5.00 and the intercompany storage is eliminated in consolidation and the market price to others is greater than cost.			$400.00
Item B.			
Corporation X values its inventory @ $7.50 per ton (not loaded) representing the cost of production plus the depletion of $2.50 per ton. This is equal to its sales price to Y and less than sales price to others.	75.00		
Corporation Y values its inventory at $10.00 per ton representing the total cost of production and loading at which it purchases from X plus the cost of transportation to its plant This cost is less than the sales price to others.		100.00	
Inasmuch as there is no intercompany differential, the values for consolidated statement purposes are the same as stated for the individual companies.			175.00
Item C.			
Corporation X values its inventory at $32.40 per unit, its net cost of $50.00 less 10/10/20, as this price is less than the net realization value of $40.50 per unit realized on sales to Corporation Y.	324.00		
Corporation Y values its inventory at its cost of $41.00 per unit as it cannot acquire the supplies at a lower figure.		410.00	

In consolidation the inventory at X will be valued as above, but the inventory at Y will be valued at the net cost to X plus the freight to Y or $32.90 per unit. 10 @ $32.40 $324.00 10 @ $32.90 $329.00 The intercompany differential is eliminated.			653.00
Item D.			
Corporation X values its inventory @ $29.00 per unit, its cost, as that is lower than its realizable value.	290.00		
Corporation Y should value its inventory at $32.50 per unit as that is the price at which the item can be obtained on the market and is less than the realizable amount upon resale.		325.00	
In consolidation the inventory at X would be valued at cost as above and the inventory at Y would be valued at the cost to X plus freight of $2.00, eliminating the intercompany differential of $6.00. 10 @ $29.00 $290.00 10 @ $31.00 $310.00 This value is less than market and less than realizable value upon resale.			600.00
Item E.			
Corporation X values its inventory @ $5.00 representing market which is lower than cost.	50.00		
Corporation Y values its inventory @ $5.75 being its invoice cost plus freight. This value is less than realizable value on resale.		57.50	
In consolidation the same inventory prices would be used, representing in both cases the lower of cost or market.			107.50

No. 3 (20 points)

a. In the case of joint products, it is necessary to allocate the costs, up to the point of split-off, to the various joint products. Like joint products, by-products come into existence at the point of split-off. However, by-products are generally assigned no part of the original cost incurred up to the split-off point. If any of the cost is assigned to by-products it is usually determined in some arbitrary manner. The full amount of material, labor, and burden cost is charged to the principal product, but the by-product must be charged with its costs after point of separation. The chief problem in accounting for by-products is to ascertain either the value assigned to them, or the revenue they will bring in, which is credited against the cost of the principal product.

b. The decision as to whether an item should be treated as a joint product or as a by-product rests on practical consideration rather than on any well defined theory. The decision is made to treat an item as a by-product if it is of little value in relation to the other product or products. If it is sold without much additional processing it is more likely to be considered a by-product than if it requires considerable additional processing. Also if it can be, and is, sold

readily at a relatively fixed market price so that there is never much inventory on hand to present a valuation problem, the by-product treatment is appropriate.

c. The two principal methods of assigning joint costs to joint products are to make the assignment on the basis of quantities or on the basis of relative sales values.

Ordinarily the assignment of joint costs is made on the basis of relative sales values of the products since this takes account of quantity differences and price differences. If, as frequently is the case, the products require additional processing after separation, that cost is taken into account and what is frequently referred to as the "reversal of the sales value" method is applied. That involves deducting the separate processing costs of each product from its sales value and making the split of joint costs on the basis of these net values. This method is appropriate under almost any circumstances.

However, the assignment of costs to each joint product may be made on the basis of quantity alone in some circumstances. This assignment on the basis of units (gallons, pounds, feet, etc.) will be satisfactory where the unit prices are about equal after deducting subsequent processing costs. If prices vary much, the method is likely to result in the costs assigned to some product exceeding its net sale value with a resulting problem as to inventory valuation.

Group II

No. 4 (12 points)

a. 1. Under the unit basis each individual unit of property, such as a single machine, is subjected to its rate of depreciation based on its estimated useful life. While a unit of property may be defined so as to be less than an entire machine or an entire building, it ordinarily will not be larger than the smallest unit in which assets are purchased or constructed.

2. Under the group basis all units of like property, such as trucks, presses, etc., are considered alike for depreciation purposes. The units making up the group are similar and are presumed to have about the same life expectancy.

3. Under the composite basis, sometimes termed the "blanket-rate" basis, assets with varying lives and of varying types may be combined for purposes of computing depreciation. All buildings at one location might be combined or all machinery in one plant might be combined. In setting the depreciation rate, the amounts and estimated lives of the various assets should be considered, but after the rate is established it is applied to the total value of the assets.

b. Under the unit basis only the allowance accumulated on the specific unit is considered when the unit is retired. That may result in the recognition of a gain or a loss on the retirement. However, under both the group and the composite plans, any unit retired is considered to be fully depreciated and there is no recognition of gain or loss until all assets are retired.

c. The principal arguments for the group and the composite methods are that they are easier to apply than the unit method with a substantial saving in detailed recordkeeping, and that they will result in a more useful charge to income because of their recognition that depreciation estimates are based on averages and therefore gain or loss on an individual asset is of little significance. Depreciation can be expected to work out only over a period of time and when taken on a number of similar items.

The principal argument against the group and the composite method is that they may conceal faulty estimates for a long period of time and, through failure to recognize gain or loss, not correct for changes in usage or for other errors. Also, it may be pointed out that the composite basis requires a comprehensive calculation originally and as the composition of the assets change, should be recomputed and adjusted.

No. 5 (12 points)

a. The LIFO method of inventory valuation assumes that the cost of the last acquired materials should be charged to current operations. It may be argued that the LIFO method, being based on the assumption of a certain permanency of a part of the stock, requires that this part be taken up at cost at the time of acquisition of the LIFO inventory without an adjustment to a lower market value, which may be temporary.

However, the "cost or market, whichever is lower" reasoning is that no amount of cost should be carried forward as inventory unless it appears to be recoverable in the following period on the basis of prices existing at balance-sheet date. This reasoning need not exclude inventory, the cost of which has been determined under the LIFO method. (Other objections to this write-down may arise from those critical of the "lower of cost or market" rule as applied to any cost basis, but these do not appear to be within the scope of this question.)

b. Under the regulations for federal income taxes the LIFO method is permissible only on the basis of cost. An adjustment to market value is not allowed in computing the tax.

c. Assuming that the write-down is made, the raw material inventory will be stated on the balance sheet at "cost on LIFO basis, or market if lower." It seems preferable to show the amount of adjustment to the lower market value as a separate figure in the statements identified as a deduction from "LIFO cost." If only a final inventory figure is shown, the amount of the write-down should be disclosed in a footnote or by a parenthetical disclosure in the body of the statement.

On the income statement, if the amount of adjustment is material it seems preferable to use 'LIFO cost" in the computation of cost of goods sold and to disclose the amount of the adjustment "as a charge separately identified from consumed inventory costs described as cost of goods sold." (See AIA, Accounting Research Bulletin No. 43, Chapter 4, par. 14.)

A possible alternative to the above income charge may be considered for corporations which adopted LIFO at a time when the carrying value (at

"cost" or "lower of cost or market") of inventories affected was greater than the valuation placed upon them for the purpose of conversion to LIFO. For some corporations this circumstance necessitated a write-down of inventories with a corresponding charge to Retained Earnings. It may be argued, in such cases, that a subsequent substantial and unusual write-down necessitated by the application of the "lower of LIFO cost or market" rule is essentially a recognition that the first valuation for LIFO purposes was not sufficiently low and requires further adjustment. If this reasoning is granted, so much of the charge resulting from such write-down as is attributable to the need for correction of the original valuation properly may be charged to Retained Earnings.

No. 6 (12 points)

a. If material as in this case, the amount of annual rental and the remaining years a lease is to run should be disclosed in a footnote to the financial statements. Both the SEC and the committee on accounting procedure of the AIA have specifically called for this disclosure. In general, information about any large and long-term or unusual commitment should be disclosed because of its importance in future operations. A rental expense of $1,000 a month should, of course, be reflected in the accounting statements.

b. The cost of the improvements should be recorded in a separate asset account. The cost should be amortized over ten or twenty years depending on whether or not the client intends to renew. In the absence of a clear indication of intention to renew, the custom is to amortize over the original term.

   In the balance sheet, the leasehold improvement may be shown as one amount net of amortization. Disclosure of both original cost and amortization to date, as is usual for machinery and other fixed assets, is not usually considered necessary for leasehold improvements. Sufficient information for analysis or interpretation is considered to be obtainable from the statement footnote relating to the lease. In particular cases, however, adequate disclosure may necessitate showing the original cost and the accumulated amortization separately. Materiality is an important consideration here.

c. The removal cost constitutes an expense of using the leasehold improvements in the same way that amortization is an expense. A portion of the removal cost should be charged to expense each year over the same period as the improvements are amortized and credited to a liability account. This account should be shown on the baalnce sheet under some such title as "Portion of estimated cost to restore leased property which has been charged to operations to date."

No. 7 (12 points)

a. 1. Fixed assets should be converted at the rates of exchange in effect at the time the asets were acquired by purchase or construction.
   2. Inventory of goods acquired by a foreign branch in that country would be converted at the current rate at balance-sheet date.

b. The bases do differ. The applicable principles are as follows:

   There is a general accounting principle which requires that profits and

retained earnings shall not be affected by valuing fixed assets at market prices. According to this principle, it is improper to convert branch fixed assets at current exchange rates if such rates are higher or lower than the rates prevailing at the dates of acquisition of the fixed assets, because the assets would be written up or down as a result of the market fluctuation. Generally the rule for translation of fixed assets at rates in effect when the asset was acquired or constructed should be followed. One exception to this rule might be with respect to current plant additions when income is translated at post devaluation rates. When, however, fixed assets are purchased with United States dollars or when they are purchased in foreign currencies out of unrestricted profits, the dollar equivalent of the foreign currency at the date of purchase should be recognized as the amount at which the asset should be carried.

The conversion of inventory at current rates is in accordance with the usual rule for valuation of current assets. The branch would value its inventory in terms of foreign currency following the "cost" or the "cost or market" rule. This inventory is presumably liquid and soon can be converted into cash, which in turn is presumed to be available to the company at the current rate of exchange.

No. 8 (12 points)

Although consolidated statements have a very real usefulness for purposes of presenting a composite picture of the financial condition and operating results of a group of affiliated corporations, they cannot be regarded as properly taking the place of statements for the individual companies for certain purposes. A consolidated statement ignores important legal relationships and presents statements of an "economic entity." Where there are important interests in the individual company, the following may be significant limitations.

Minority stockholders of a subsidiary can obtain very little information of value to them from consolidated statements, for such statements do not detail the assets, liabilities, income, and expenses of the subsidiary.

The creditors of each company are primarily concerned with the financial condition and earnings of the specific debtor company.

It is often difficult to show in a consolidated balance sheet, the liens that affect the rights of creditors.

Since a consolidated statement is a composite, a weak current position of one company may be bolstered by a strong current position in another company; for this and other reasons, the consolidated balance sheet cannot be regarded as reflecting the current position of the parent company.

Bond indentures frequently require the maintaining of specified ratios of current assets to current liabilities, and provide penalties for nonconformance. A consolidated balance sheet does not give the bondholders of individual companies information from which they can determine whether the requirements are being fulfilled, nor can the stockholders see whether their company is in any jeopardy because of default.

Since in consolidation a consolidated retained earnings account is shown on the balance sheet, the amount of retained earnings available for use in paying dividends to the stockholders of the parent is not shown on the statement.

If assets of foreign subsidiaries represent a considerable portion of the consolidated total, very misleading conclusions may be reached if the consolidated balance sheet includes foreign cash subject to widely fluctuating exchange rates or to exchange restrictions, or if it includes foreign receivables subject to extraordinary collection hazards, or if it includes merchandise manufactured and/or labeled specifically for foreign sales.

It is, of course, obvious that a consolidated income statement does not show the operating results of individual companies. A family of companies may be able to carry a weak member, but the strength of the organization is enhanced if each affiliate carries itself.

Ratio analyses based on consolidated data are not reliable. In the first place, such ratios are composites, and the good and bad features of individual companies are not disclosed. In the second place, the ratios are affected by intercompany eliminations.

No. 9 (12 points)

Deciding whether the contractor should take up revenue on the "completed contracts" basis or on the "percentage of completion" basis involves the following considerations:

1. Ability to estimate. Where a high degree of risk is involved, as in certain salvage contracts, it may be impossible to make a reasonable estimate of the percentage of completion. The percentage of completion basis would be least appropriate in such cases. At the other extreme, there is no problem of estimating when the contract calls for payment at cost plus a set per cent of cost. The percentage of completion basis would be most appropriate in such cases.
2. Effect on annual income. If there are numerous small contracts with short completion periods there probably would be no material difference in recorded profits between the two methods. This would indicate the use of the completed contracts basis if for no other reason than simplicity. If the business is seasonal and no contracts are in progress at the close of the fiscal year a similar situation exists. However, if there are a few large contracts extending over a long term, consideration should be given to using the percentage of completion basis.
3. Tax effects. The tax consequences of the decision, both short and long run, should be considered in arriving at a decision.
4. Time of revenue realization. Contracts may call for periodic payments as the construction is in progress. This would indicate that the percentage of completion basis is appropriate. Also, it normally indicates that it is possible to make reasonably accurate estimates of progress. On the other hand, if payment is to be made only on completion, there is less reason for the percentage of completion basis even when reasonable estimates of progress can be made.
5. Business organization and financing. There is less reason to use the percentage of completion basis in a proprietorship or a closely-held corporation

than in a corporation with widely distributed shares. This is true because accounting setatements serve management and absentee stockholders in different ways. Absentee stockholders might well be misled by statements which did not disclose estimated profits on large, long-term contracts.

No. 10 (12 points)

Generally a change in accounting methods cannot be made without permission of the Commissioner. Special exceptions and/or requirements for the given cases are as follows:

a. The use of the retail method must be designated on the return and is available for tax purposes to retail merchants only. Books of account must have been kept consistently and accurately on a basis of retail method for the entire accounting period for which return is made. The retail method must be used in all subsequent years, or until the Commissioner authorizes a change.

b. The installment method may be introduced at any time by a person who regularly sells personal property on the installment plan and who keeps books of account which enable an accurate computation to be made on this basis. It may also be used by a person who sells real property if the initial payments (within the taxable year) do not exceed 30 per cent of the selling price and for casual sales of personal property for a price not exceeding $1,000 and where the initial payments do not exceed 30 per cent of the selling price. In computing the income for the year of change and any subsequent year amounts received on account of sales in prior years shall not be excluded.

c. Whereas generally a change in accounting method must be applied for within 90 days after the inception of fiscal year, the LIFO method may be introduced by filing an application (Form 970) attached to the tax return. Complete specification must be made with regards to the selections of the "pools" on which LIFO will be applied.

   The beginning inventories of goods to which LIFO is to be applied must be adjusted to cost in the manner prescribed by regulations. If LIFO is used for tax purposes, it must also be used in preparing annual financial statements for credit purposes or reports to owners.

Auditing

November 5, 1953; 9 a.m. to 12:30 p.m.

No. 1 (12½ points)

a.
1. Review the client's inventory instructions and procedures before the date of the physical count.
2. Attend and observe the inventory taking on the selected date.
3. Make test verifications of the measurements used in determining inventory quantities. This may require consultation with experts. Note also railroad car numbers for later comparison with bill of lading as to quantities.
4. Obtain control figures on the inventory quantities.
5. Compare results of the physical inventory to balances shown by perpetual inventory records.
6. Make further inquiry including a recount in the case of any material differences.
7. Determine the pricing basis used in prior years and that current year's basis is consistent and factual.
8. Extend and foot inventory sheets.
9. Ascertain that perpetual inventory records are adjusted to actual and that the inventory adjustment is taken into the general ledger.
10. Verify that cut-off on inventories has been effective both as to sales and purchases, that liability has been recognized for material on hand for which payment had not been made at May 31, 1952, and that inventory in transit has been properly accounted for.
11. Obtain letter of representation concerning inventories.

b.
1. Review internal control as to inventories, purchasing, receiving, shipping, and selling functions.
2. Apply gross profit tests as to total sales and sales by each type of coal. Compare gross profits with prior years.
3. Accumulate the tonnage of all purchases during the current year of a particular type of coal, as shown by vendor's invoices. Add the total so obtained to the perpetual inventory quantity shown at May 31, 1951, and subtract recorded sales of this type during the year ended May 31, 1952. Compare the resulting figure with perpetual inventory balance at May 31, 1952, and with the result obtained by physical count.
4. Review quantity balances as shown by perpetual inventory records at May 31, 1951, as to reasonableness of amounts in comparison with other years. If at variance from normal quantities, an explanation should be obtained of the reason for the variation.
5. Review prices and extension of perpetual inventory cards at May 31, 1951, and determine that the total dollar amount of the perpetual inventory records agrees with the general ledger account.

No. 2 (12½ points)

a. A situation in which the auditor cannot express an opinion because his exceptions are such as to negative the opinion would involve the following factors:

1. A violation of generally accepted accounting principles.
2. Material distortion of the financial statements as a result of the violation.
3. A branching out of the effect of the violation throughout the financial statements which precludes a simple explanation by the auditor in his short-form report. For example, a failure to segregate earned and paid-in surplus would call for a qualified opinion and would not negative the opinion. In contrast, an improper inventory basis could affect balance sheets and income statements of past, current, and future years. These effects could not be explained without virtually recasting the statements.
4. Judgment by the auditor that the statements would be misleading as a result of the violation.

The following is an example of a situation in which the auditor cannot express an opinion because his exceptions are such as to negative the opinion: the client values inventory at standard cost without adjusting for significant amounts of over-applied burden, labor, and material. The effect of this violation of generally accepted accounting principles is a material distortion of current assets, total assets, working capital, retained earnings, cost of goods sold, and net income.

b. The following factors would be involved in a situation in which the auditor cannot express an opinion because his examination is inadequate in scope:
   1. Omission of a procedure or procedures which the auditor considers necessary. A special case is the omission of a generally accepted auditing procedure whether or not the auditor considers it necessary, unless he can satisfy himself by other means. In this case, even though he considers the procedure to be unnecessary, the auditor bears the additional burden of proving it to be unnecessary.
   2. Judgment by the auditor that there is some degree of risk of misstatement as a result of the restricted examination.
   3. Judgment by the auditor that the possible misstatement would be material. In this connection, the auditor must consider possible misstatements of related items. For example, if the audit of inventories is restricted, the possible misstatement of receivables, payables, and net income must be considered as well as the possible misstatement of inventory.

The following is an example of a situation in which the auditor cannot express an opinion because his examination is inadequate in scope: the client conducts a merchandising business and most of the assets are receivables or inventory. Most of the receivable records are maintained at branch offices and most of the inventory is at the branches. The auditor's examination is restricted to the home office.

c. We have examined the balance sheet of X Company as of December 31, 19—, and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances except that we did not observe the taking of branch inventories, confirm branch receivables, nor audit branch records. According

to the accompanying financial statements, branch inventories account for—% of total inventories and branch receivables for—% of total receivables. Because of the restricted nature of our examination as described above, we are unable to express an opinion on the accompanying financial statements as a whole. Inventories and receivables shown in those statements include amounts taken from unaudited branch office reports.

No. 3 (12½ points)

a. Procedures that would ordinarily be followed for verification of the liability for royalties payable in making an annual audit would be affected by the materiality of the amount, internal control, and work done in prior years. Since this is a new contract the work probably would include:
   1. Read the licensing agreement and make extracts.
   2. Examine correspondence with the license grantor and review royalty statements already submitted.
   3. Check production records (and inventory and shipping records) to ascertain the number of tubes manufactured under the agreement.
   4. Calculate the royalty payable, making adjustments as necessary for royalties which have been paid.
   5. Request a confirmation from the license grantor as to the amount of the royalty due.

b. This report, as are all reports, must be based on the examination made and on the findings of the examination. Since this was not a special investigation but work performed in connection with an annual audit, it would be appropriate to start with reference to the annual audit and the usual statements as to scope. However, it also could be treated as a special report. In that case, the report should start with a statement of the agreement as you understand it; list the procedures followed in the audit, and summarize the transactions, including any adjustments you found to be necessary. The report might be somewhat as follows:

   To Patent Owner (name)

   At the request of the T.E.L. Video Corporation, we have examined their records relating to the amount of royalty payable in 1952 under their agreement with you dated ——— —, 1952.

   Our understanding is that the agreement provides that the T.E.L. Video Corporation will pay a royalty of ten cents for each radio tube manufactured under Patent No. —; that such payment will be made within 30 days of the close of each calendar quarter; that within 10 days of the close of each quarter they will submit to you a statement of tubes manufactured, to be certified to by an officer of the company; and that you have the right to examine the records of the company as they affect amounts due to you. The agreement is for a five year period, but there is no guarantee as to the quantity to be produced during the period of the agreement.

   We examined the production records of the T.E.L. Video Corporation as they related to the manufacture of this tube. Production was first started in April, 1952. Due to production difficulties 12,420 of the tubes put in

process during April and May were defective. Defective tubes since that date have averaged about 5 per cent of production and have been deducted from tubes put in process. We also made an over-all tie-up of sales and inventory with production and found the records to be substantially in agreement. We discussed the production of the tube with company officials and employees.

Payments made to you as well as the amount of royalty payable based on production of good tubes is shown in the following schedule:

(Signed)

SUMMARY OF ROYALTY PAYABLE April 1, 1952, to December 31, 1952

Tubes placed in production		306,750
Tubes rejected as a result of inspection or spoiled during production		31,360
Good tubes produced		275,390
Royalty @ $.10 per tube		$27,539
Payments made:		
July 26, 1952	$ 1,575	
October 30, 1952	12,380	13,955
Royalty payable as of December 31, 1952		$13,684

No. 4 (12½ points)

1. *Internal control.* Is internal control adequate? If not, what extension of procedures was necessary and what suggestions should be made to the client to improve the system of control?
2. Are all parts manufactured or are some purchased. If they are manufactured, how frequently are parts for old models produced.
3. *Auditing standards.* Was the audit in accordance with generally accepted auditing standards? Was the taking of physical inventory observed?
4. *Inventory cut-off.* How was the movement of parts controlled during the inventory count? Were sales and purchases or transfers from work in process properly cut-off?
5. *Pricing Policy.*
   a. Is the pricing method in accordance with generally accepted accounting principles?
   b. If not, is the inventory of repair parts material in amount?
   c. Is the pricing method acceptable for tax purposes?
   d. Is the valuation method in accordance with trade practice?
   e. Is the valuation method consistent with that used in prior years?
   f. Were obsolete parts valued at a nominal amount?
   g. Is there a balanced inventory or are parts on hand in excess of requirements?
   h. How fast does the value of parts decline in the late years of the model's life?
   i. How many parts were written off as obsolete and having only scrap value?
   j. Is cost below net realizable value?

6. *Verification of quantities, extensions, costs.* What tests were made of inventory prices, quantities, and extensions? Were costs checked to determine the reasonableness of the percentage reduction of list prices?
7. *Consignments.* Are parts shipped to dealers on consignment? Does the inventory include dealers' part returned for repairs?
8. *Encumbrances.* Are there mortgages or liens against the inventory?
9. What adjustment did you recommend? Why? Did client agree?
10. *Disclosure.* Does the balance sheet adequately disclose the valuation basis of the parts inventory? Is there disclosure of any liens on the inventory?
11. *Statement presentation.* Is the repair parts inventory a current asset? Is the inventory properly classified on the balance sheet?

No. 5 (12½ points)

The work on maintenance work orders would be intended primarily to test the internal control and to establish the principle followed by the Irving Manufacturing Company in distinguishing between asset additions and current expense. It should include the following:

1. Compare the expense with that incurred in previous years. From this comparison some idea can be obtained as to the reasonableness of the expense this year by taking into account changes in volume and any other known factors that might probably cause a change.
2. Obtain or prepare an analysis of the control account. This serves to show regularity of monthly entries and identify and unusual or nonrepetitive entries to be investigated.
3. Obtain a list of special orders or the file of completed orders. Inspect a number of them for description of work, authorization and approval, budgeted amount and actual amount. Select a few orders for investigation, basing the selection on descriptions which indicate the possibility of the item being an asset addition, or orders where the actual varied substantially from the budget, or orders on which there appears to be a disproportionate amount of labor or of purchased parts, etc. This procedure is useful in determining the accounting principle followed and that elements of the internal control system are functioning.
4. Investigate the special orders selected, discussing the nature of the work with company employees, actually inspecting the work where that would be helpful, checking labor and material back to payroll summaries and store issues or vouchers. Attention should be given to the likelihood that the type and amount of labor charged would be needed and that the parts or supplies used would be needed for the job as described. This work helps to establish that the accounting is accurate and that the work is a proper maintenance charge.
5. Scan the charges to standing orders. If there are any marked irregularities, investigate the charges for those months. This should establish the reasonableness of the costs accumulated on the standing orders.
6. From the analysis of the control account, pick any unusual items for investigation back to whatever supporting data that are necessary to establish the nature of the expenditure. Also, select one month's charges from special

and standing orders to be tied in with the open orders for that month. This tests the completeness of the detail supporting the charges. (The company may have a schedule of orders showing monthly charges to each order. In that case this work is unnecessary but the amounts per schedule would be tied in with the control.)

7. If tests have not been made of the data supporting payroll summaries and of the data supporting material issue summaries, such tests of the accuracy of the records might be made in connection with maintenance expense.
8. The company policy as to distribution of overhead to all types of work orders would be reviewed, but ordinarily that would be done separately from the investigation of maintenance costs.

No. 6 (12½ points)

a. The procedures to be followed in the investigation would include the following:
   1. Verify the closing inventory of shoes in dollars and numbers of pairs.
   2. Reconcile cash month by month for the past year, tying up bank and book records.
   3. Obtain or prepare comparative income statements from the time the business was started to the date of the bankruptcy petition.
   4. Determine the normal gross profit percentage.
   5. Inquire and investigate to determine if there were additional investments, borrowings, or other sources of cash besides sales, and to determine the extent of drawings and other uses of cash besides operating costs. Look for evidence of special selling expenses.
   6. Check newspaper advertising for 1952 and the early part of 1953 to determine if there is substance to the statement that the shoes were sold at very low prices.
   7. Check with neighboring stores and competitors to ascertain the truth of the assertion as to sale prices.
   8. Look for any changes in the methods of record keeping which occurred about the time of the period of abnormal activity which ended in bankruptcy. Seek reasons for any changes which may be found.
   9. Inquire as to the general reputation Thomas has in the community.

b. In a report you ordinarily would:
   1. Summarize your findings in a statement which shows cash receipts, cash disbursements, and closing cash position on the following bases:
      a. Sales at amount necessary to result in the cash and inventory position reported in the bankruptcy petition.
      b. Sales at amount indicated by application of normal gross profit percentage and a derived closing cash position.
      c. Sales at amount indicated by arbitrarily selected gross profit percentages which are between the percentages shown in "a" and "b" of the schedule, and derived closing cash positions.
   2. Prepare a narrative to accompany the statement in which the assumptions on which each calculation is based are discussed.

No. 7 (12½ points)

a. Cash registers contribute to the effectiveness of internal control over receipts from cash sales in the following ways:

1. By tending to assure that all cash sales are recorded and that they are recorded properly.
   (a) By the automatic issuance of customers' receipts or the imprinting of sales slips.
   (b) By the publicity given to sales by the ring of a bell and the tab display of the amount recorded.
2. By establishing definite accountability for cash.
   (a) By making readily available the total amount of sales which permits rapid proving-out of cash at any time. This establishes accountability for cash receipts in much the same manner as the imprest system establishes accountability for petty cash.
   (b) By providing several cash drawers and accumulating separate totals for each. This permits definite accountability even though several salesmen use the same register.
3. By providing a reliable record of cash sales.
   (a) By providing a tape listing of all transactions and totals by classes of transactions. This tape can be used as a posting source and kept as as a permanent record.
   (b) By providing for independent control of the tape by its concealment under lock and key. This prevents the salesmen from tampering with the record.

b. 1. The payroll section needs the following information:
   (a) Employment and rate authorizations. These would be obtained from the personnel department.
   (b) Payroll deduction slips. These would be obtained from the personnel department.
   (c) Hours worked by each employee. These would be obtained from clock cards kept in the timekeeping department.
2. The cost distribution section needs the following information:
   (a) Labor hours by jobs, products, processes, or departments, depending upon the costing method followed. These would be obtained from job time tickets kept by the worker, by timekeepers, or by factory foremen.
   (b) Wage rates by labor grades. These would be obtained from the personnel department.
3. The principal payroll controls in the system described above are:
   (a) Independent calculation of total payroll by each of the sections using different sources of information.
   (b) Separation of payroll and personnel duties which makes possible effective control and audit of the payroll.

No. 8 (12½ points)

1. Review the system of internal control as it relates to these loans.
2. Check the opening ledger balance to last year's working papers.
3. Scan the ledger control account and investigate any unusual entries which you observe.
4. Prepare or obtain from the association a schedule of loans outstanding on savings accounts at date of audit. Schedule should show: (a) number of loan; (b) date of loan; (c) name of borrowers; (d) interest rate; (e) amount of loan; (f) amount and number of savings account pledged as collateral; (g) balance of loan unpaid; (h) amount of accrued interest; (i) amount of present collateral.
5. Verify footings of the schedule and check totals for both loans and interest to related control accounts. If schedule was not prepared by auditors, check loans and interest against subsidiary ledger accounts.
6. Determine whether loans conform to the provisions of applicable federal and state laws and regulations and to regulations of the association.
7. Test-check loans made during the period to specific authorizations in the minutes of the board of directors.
8. Review individual loan balances to see that they do not exceed the collateral balances.
9. Inspect notes and collateral (savings account passbooks) and check to schedule. Inspect for completeness, proper execution and assignment of collateral. Test-check signatures to signature file.
10. Test-check loan balances and dates to which interest has been paid by direct communication with the borrowers (positive-type confirmation request).
11. Ascertain the association's method of computing interest and satisfy yourself that it is proper. Test-check interest calculations sufficiently to determine that the method is being followed consistently and is being applied properly. Where feasible, make an over-all test of the reasonableness of the amount of interest taken into income.
12. If a reserve for uncollected interest is maintained in accordance with federal or other regulations or policies, test the adequacy of such reserve in light of applicable regulations or policies.

No. 9 (12½ points)

The National Committee on Municipal Accounting[1] lists the following statements as essential for an annual financial report of a municipality:

1. A balance sheet for each fund. If a single balance sheet is prepared covering the several funds it should be in columnar or sectional form so as to exhibit the accounts of each fund individually.
2. An analysis of the surplus of each revenue fund, department, or institution that is operated as a distinct financial entity. This statement would show for each such fund or department the balance of unappropriated surplus at the beginning of the period, the excess of revenue over expenditures or the reverse for the period, other items increasing or decreasing unappropriated surplus, and the

[1] Now changed to "National Committee on Government Accounting."

balance of unappropriated surplus (or deficit) at the end of the period.

3. Statements of revenue for each revenue fund and comparisons with budget estimates. These statements would show the various sources of revenue, the budget estimates for each, the amount realized and the excess or deficiency of actual over estimated.
4. Statements of expenditures of each revenue fund and comparison with budget estimates. These statements would show the appropriations for the year classified by function and department. The expenditures for each appropriation, unliquidated encumbrances for each appropriation and the balance, if any, of each appropriation at the end of the year.
5. Operating statements for each utility for public service enterprise. These statements should be in such form as to show the true results of operation of each enterprise.
6. Statements of receipts and disbursements of each of the various special funds, such as, trust funds, bond funds, sinking funds, special assessment funds.
7. Summary statement of receipts and disbursements of all funds.
8. Statement of changes in fixed asset accounts. This statement should show book value of fixed assets at the beginning of the year properly classified as to land, buildings, other improvements, equipment; additions during the year by expenditures from capital funds; additions through budget expenditures of the various departments for equipment and other capital items; deductions due to property disposed of or discontinued from service; the book value of property at the close of the period.
9. Debt statement. This statement should show the changes in all items of fixed indebtedness during the year and the amount outstanding on account of each issue at the close of the year.

Commercial Law

November 6, 1953, 9 a.m. to 12:30 p.m.

Group I

No. 1 (10 points)

a. 1. The buyer may maintain an action against the seller for damages for non-delivery where the property in the goods has not passed to the buyer and the seller wrongfully neglects or refuses to deliver the goods. (Subsection 1, Section 67, Uniform Sales Act.)

2. The seller may maintain an action against the buyer for damages for non-acceptance where the buyer wrongfully neglects or rufeses to accept and pay for the goods. (Subsection 1, Section 64, Uniform Sales Act.)

b. The buyer may, at his election, (*1*) accept or keep the goods and set up against the seller the breach of warranty by way of recoupment in diminution or extinction of the price; (*2*) accept or keep the goods and maintain an action against the seller for damages for the breach of warranty; (*3*) refuse to accept the goods, if the property therein has not passed, and maintain an action against the seller for damages for the breach of warranty; (*4*) rescind the contract to sell or the sale and refuse to receive the goods or, if the goods have already been received, return them or offer to return them to the seller and recover the price or any part thereof which has been paid. (Subsection 1, Section 69, Uniform Sales Act.)

c. When the buyer has claimed and been granted a remedy in any one of the ways set forth in Answer (b), no other remedy can thereafter be granted. (Subsection 2, Section 69, Uniform Sales Act.)

d. The measure of damages is the loss directly and naturally resulting, in the ordinary course of events, from the breach of warranty. (Subsection 6, Section 69, Uniform Sales Act.) Subsection 7, Section 69 of the Uniform Sales Act indicates that such loss, in the case of a breach of warranty of quality and in the absence of special circumtances showing proximate damage of a greater amount, is the difference between the value of the goods at the time of delivery to the buyer and the value they would have had if they had answered to the warranty.

No. 2 (10 points)

a. Tender of performance is an offer to perform a condition or obligation coupled with the present ability of immediate performance, so that were it not for the refusal of cooperation by the party to whom tender is made the condition or obligation would be immediately satisfied. (*Williston on Contracts,* Revised Edition, 1938, Section 1808.)

b. Yes. If at or before the time of his payment the debtor specifies the application which is to be made of the payment, this direction must be followed by the creditor. (*Williston on Contracts,* Revised Edition, 1938, Sections 1795 and 1796.)

c. 1. If the debtor directs application to the principal, the payment, if accepted, must be so applied. (*Williston on Contracts,* Revised Edition, 1938, Section 1795.)

2. There is a split in authority as to whether, in the absence of a direction by the debtor, the creditor can apply the payment to either principal or interest or to both at his election or whether he must apply it to interest before any application can be made to principal. (70 Corpus Juris Secundum, Payment, Section 58, and cases there cited.) If neither party directs application of the payment, the court is compelled to make the application itself, and in such circumstances the payment will be applied to interest which has become due rather than to principal. (*Williston on Contracts,* Revised Edition, 1938, Sections 1800 and 1801.)

No. 3 (10 points)

a. $3,000. In the absence of any contrary agreement, each partner shares equally in the profits. (Uniform Partnership Act, Section 18(a).)

b. Every partner is an agent of the partnership for the purpose of its business, and the act of every partner for, as here, apparently carrying on in the usual way the business of the partnership binds the partnership unless the partner is acting in contravention of a restriction on his authority and the person with whom he is dealing has knowledge of the restriction. Thus, here, the partnership is bound if X had no knowledge of A's lack of authority; otherwise, the partnership is not bound. (Uniform Partnership Act, Sections 9(1) and (4).)

c. No. The majority of the partners can control the ordinary decisions of a business but a fundamental change in the business requires unanimous consent. Here, the opening of a hardware store in a distant city would be a major change. (Uniform Partnership Act, Section 18(e); 18(h).)

d. Yes. Where title to real property is in the name of one partner and the record does not disclose the right of the partnership, a conveyance by the partner in whose name the title stands to a purchaser for value and without knowledge of the partnership interest binds the partnership. (Uniform Partnership Act, Section 10(3).)

e. No. A partner can, without the consent of the other partners, assign his beneficial interest in the partnership, i.e., his right to his share of partnership profits and, upon dissolution, its assets; the assignee does not in this case become a partner and is not entitled to take part in the management of the partnership. (Uniform Partnership Act, Section 27.)

No. 4 (10 points)

a. 1. The note becomes a bearer instrument. Section 9(3) of the U.N.I.L. provides that an instrument is payable to bearer when it is payable to the order of a fictitious or nonexistent person and such fact was known to the person making it so payable.

2. A bill of exchange may be protested by a notary public or by any respectable resident of the place where the bill is dishonored in the presence of two or more credible witnesses. (U.N.I.L. Section 154.)

3. An indorsement in blank is an indorsement specifying no indorsee; such an indorsement makes the instrument payable to bearer so that it may be negotiated thereafter by delivery alone. A special indorsement is one which specifies the person to whom or to whose order the instrument is payable

and the indorsement of such person is necessary for further negotiation of the instrument. (U.N.I.L. Section 34.)

b. 1. D is not liable. The acceptance by P was a qualified acceptance since it changed the tenor of the draft as to the time of payment. If a holder, in this case X, takes a qualified acceptance, the drawer is discharged unless he has authorized the holder to take such an acceptance. (U.N.I.L. Sections 141(4) and 142.)

2. The holder may refuse to take a qualified acceptance, and if he does not obtain an unqualified acceptance, he may treat the bill as dishonored by nonacceptance and, after necessary proceedings on dishonor are duly taken, recover from the drawer. Where, on the other hand, as here, a qualified acceptance is taken, D, the drawer, is charged from liability, unless he has expressly or impliedly authorized the holder to take a qualified acceptance, or subsequently assented thereto. If the drawer receives notice of a qualified acceptance, he must, within a reasonable time, express his dissent to the holder, or he will be deemed to have assented thereto. (U.N.I.L., Sections 61 and 142.)

No. 5 (10 points)

a. "Blue sky" laws are those regulating the issuance of and dealing in securities. The blue sky legislation of different jurisdictions differs considerably in scope and phraseology, but its basic purpose is to protect the investing public from unfair or deceptive practices in connection with the sale of securities. It takes its name from its object which is to prevent promoters from selling "the blue sky" to investors or, at least, from promising it to them. (Fletcher, *Cyclopedia of the Law of Corporations,* 1945, Sections 6734-6738.)

b. Among the more common rights and privileges of a stockholder are: (*1*) right to receive a stock certificate, (*2*) right to dividends as authorized, (*3*) right to transfer his stock, (*4*) right to vote, as authorized, at stockholders' meetings, (*5*) right to inspect and examine corporate books and records at reasonable times and places and for proper purposes, (*6*) right to sue as representative of the corporation in a proper case, (*7*) pre-emptive right to participate in new issue of stock upon an increase of capital stock, (*8*) right to pro rata distribution of assets on dissolution. (Fletcher, *Cyclopedia of the Law of Corporations,* 1945, Sections 2214, 5715, 5717.)

c. 1. There is some confusion in the authorities as to how or by what procedure shares of stock acquire the status of "Treasury Stock." According to some courts, stock that has been issued as full paid to stockholders and subsequently reacquired by the corporation is treasury stock; according to others, treasury stock is stock reserved at the time of organization as assets of the corporation. As to either type of stock, the courts are in conflict as to the existence of a pre-emptive right of stockholders to acquire the stock, but the majority view, at least where reacquired shares are concerned, is that no pre-emptive right exists. (Fletcher, *Cyclopedia of the Law of Corporations,* 1945, Section 5088 and 5160.)

2. Stockholders, or at least those holding voting shares, have a pre-emptive or prior right, as against any other person, to subscribe for or purchase stock in proportion to the number of shares of original stock held by them respectively. This right is not generally accorded where its exercise would be inconsistent with the object that the stock increase was legally designed to accomplish. Further, there is a growing tendency to restrict the right because of the increased complexity of modern corporate structure. (Fletcher, *Cyclopedia of the Law of Corporations,* 1945, Sec. 5135.)

d. The requirements of the several states as to what records a corporation must keep vary greatly. Either as a matter of practical necessity or legal duty, however, a corporation should keep minutes of stockholders' and directors' meetings, a record of the stockholders and a stock transfer book, and general books of account. (Fletcher, *Cyclopedia of the Law of Corporations,* 1945, Sections 2187 and 2188.)

Group II

No. 6 (10 points)

a. The most fundamental difference between a corporation and a partnership is that a partnership, as contrasted to a corporation, is not a legal entity distinct from its members. More specific differences include: (*1*) a partnership is created and dissolved by mere agreement of the members; a corporation's creation or dissolution requires the special authority and approval of the state; (*2*) in the absence of prior agreement, a partnership is dissolved if a partner dies or transfers his interest in the partnership (but, *cf.* Uniform Partnership Act, Sections 25 and 27); the transfer of corporate shares does not affect the corporation's existence; (*3*) a partnership may, by agreement among the members, do anything which is not unlawful; a corporation's activities are limited by its charter; (*4*) the liabilities of a partnership are liabilities of the individual partners; corporate stockholders, who have fully paid for their shares, are not personally liable for the liabilities of the corporation; (*5*) at common law, a partnership may sue and be sued in the individual names of all its members; a corporation may sue and be sued in its corporate name; (*6*) each partner is an agent of the firm; corporate stockholders in their individual capacities cannot bind the corporation in its corporate capacity unless the board of directors has so ordered. (Fletcher, *Cyclopedia of the Law of Corporations,* 1945, Section 20.)

b. "Person," as used in the Uniform Partnership Act, includes individuals, partnerships, corporations, and other associations. (Un. Partnership Act, Sec. 2.)

c. A partner winding up the affairs of a partnership acts in a fiduciary capacity. He must account to the partnership for any benefit and hold as trustee for it any profit derived by him without the consent of the other partners from any transaction connected with the liquidation of the partnership. (Uniform Partnership Act, Section 21.)

d. In settling accounts after the dissolution of a limited partnership the assets remaining after the payment of liabilities to all creditors (including limited partners except with respect to their capital contributions and not including

general partners) are distributed in the following order: (*1*) to limited partners in respect to their share of the profits and other compensation by way of income on their contributions; (*2*) to limited partners in respect to the capital of their contributions; (*3*) to general partners other than for capital and profits; (*4*) to general partners in respect to profits; (*5*) to general partners in respect to capital. (Uniform Limited Partnership Act, Section 23.)

No. 7 (10 points)

a. Allen is authorized to sell only the partnership cars. In the absence of other agreements, authority given by two principals jointly includes only authority to act for their joint account. (Restatement of Agency, Section 41.)

b. Smith's authority to charter the steamer is terminated. The authority of an agent terminates, or is suspended, when the agent has notice of the happening of an event or a change in conditions from which he should reasonably infer that the principal does not consent to the further exercise of authority. Generally, authority to perform several different acts may terminate as to some but not as to others. However, where the performance of one of two acts is dependent upon the performance of the other, the termination of authority to perform one will terminate the authority to perform the other at the same time. (Restatement of Agency, Section 108.)

c. Unless otherwise agreed, authority to sell does not include authority to rescind the terms of the sale after its completion nor to act further with reference to the subject matter except to undo fraud or correct mistake. Here, there is no indication of fraud or mistake, or that the agent had apparent authority to do more than make the sale. As the sales agent's agreement was, therefore, neither actually nor apparently authorized, it is not a bar to suit by the principal, and Albert, if he is otherwise entitled, can recover from Burt. (Restatement of Agency, Sections 66 and 311.)

d. Yes. Where a person purports to act on the account of another and the other affirms the act, the affirmance is effective as ratification if the act, both at the time it is done and at the time it is affirmed, could have been authorized by the other, as principal, and, further, if the act is one the ratification of which is not against public policy. Therefore, here, Paul can obtain the benefit of the contract by affirming George's act. (Restatement of Agency, Sections 84-87.)

No. 8 (10 points)

a. The doctrine of substantial performance is a general principle which holds that in some circumstances a failure by one party to a contract to perform his obligation is not sufficiently material to give rise to the ordinary rights and liabilities arising from a breach of contract. The doctrine is impossible of mathematically exact application, but the following circumstances are influential in its operation: the defects, deviations, or omissions in performance are or will be minor; the injured party can be adequately compensated in damages for the lack of performance; it would be a relative hardship on the party failing to perform to terminate the contract; the departure from the terms of the contract is not willful; and, the party at fault is making and will

make a bona fide effort toward full compliance. (*Black's Law Dictionary;* Restatement of Contracts, Sections 274-275; *Corbin on Contracts,* 1951, Sections 700 et seq.)

a. 1. A receipt is a written acknowledgment of the receipt of money, or thing of value. (*Black's Law Dictionary.*)
   2. A release is the giving up or abandonment of a claim or right by the person in whom it exists or to whom it accrues to the person against whom the claim exists or the right is to be exercised or enforced. (*Black's Law Dictionary;* 45 American Jurisprudence, Release, Section 2.)
   3. A mutual release is a discharge by each of two or more parties to the other or others, the consideration for each discharge being the discharge or discharges given by the others. (76 Corpus Juris Secundum, Release, Section 20.)
   4. A general release is one which discharges all existing claims of whatever kind which the person making the release has against the person to whom the release is given; it may also discharge contingent and future claims if the intent to do so is clear from the recitals of the release. (See *Nahtel Corporation* v. *West Virginia Pulp & Paper Co.,* 141 F.2d 1 (1944).)

c. The validity of a release may be attacked for fraud, mutual mistake, duress, undue influence, incapacity of the party executing the release, or lack of consideration when consideration is required. (45 American Jurisprudence, Release, pages 677, 682, 685, 686, and 689.)

d. General damages are those for such consequences as would follow a breach of contract in the usual course of events. Special damages denote actual damages arising from special circumstances beyond the normal course of events. Thus, when a seller wrongfully fails to deliver promised goods, the buyer's damage from inability to use them for a special profitable purpose he has in mind is a consequence which is not usual or to be reasonably expected by the seller and is, therefore, special damage which must ordinarily be specially pleaded by the buyer. (*Williston on Contracts,* 1937, Sections 1344 and 1344A; 15 American Jurisprudence, Damages, Section 10.)

e. Liquidated damages may refer to the amount of the damages which have been ascertained by the judgment in an action or to a specific sum of money which has been expressly stipulated by the parties to a contract as the amount of damages to be recovered by either party for a breach of the agreement by the other. (*Black's Law Dictionary.*)

No. 9 (10 points)

a. In general, a contract of suretyship is one in which one person, the surety, engages to be answerable for the debt, default or miscarriage of another, the principal. A contract of indemnity is one in which the promisor agrees to save the promisee harmless from some loss irrespective of the liability of a third person. In this sense indemnity is synonymous with insurance. (Restatement of Security, Section 82(1); 50 American Jurisprudence, Suretyship, page 903.)

b. A surety's right of contribution is his right to recover from co-sureties where, in the performance of his own obligation, he has discharged more than his

proportionate share of the principal's obligation. In the absence of agreement among the co-sureties as to the distribution of their liabilities, or where their stipulated liabilities are for the same amount, one surety who pays, for instance, the entire amount is entitled to recover from each of the others a sum equal to such amount divided by the number of persons participating. Where the risks assumed are unequal, the proportionate share is determined by the amount of risk assumed by each surety. (Restatement of Security, Sections 149 and 154(f).)

a. Able can enforce contribution from Baker as a co-surety. To invoke the doctrine of contribution between sureties, all that is necessary is that the sureties be bound to answer for the same duty of the principal and that one surety has paid more than his proportionate share of the loss. It is not necessary that there be privity of contract between the sureties and it is immaterial that co-sureties are ignorant of each other's engagement. (Restatement of Security, Sections 144, 149; 50 American Jurisprudence, Suretyship, page 1083.)

No. 10 (10 points)

a. To acquire title to real estate by adverse possession a person must take possession under a claim of right which is hostile to the true owner thereof, and his possession during the statutory period must be actual, open, visible, notorious, and exclusive. It does not destroy the exclusiveness or continuity of possession to have persons in possession who hold under or through the original adverse possessor. (Tiffany, *The Law of Real Property,* Third Edition, 1939, Sections 1135-1147.)

b. The four major types of leasehold estates are as follows:
   (1) *Estate for Years.* A tenancy limited for a certain time, as for a year, half-year, quarter-year, or any greater or lesser period of fixed duration; this estate is frequently called a "term." (Tiffany, *The Law of Real Property,* Third Edition, 1939, Section 72.)
   (2) *Estate or Tenancy at Will.* A tenancy which runs for no fixed period but is terminable at any time at the volition of either the landlord or the tenant. (Tiffany, *The Law of Real Property,* Third Edition, 1939, Section 155.)
   (3) *Estate or Tenancy at Sufferance.* A tenancy created where the tenant wrongfully retains possession of the leased premises after his previous authorized tenancy has terminated. (Tiffany, *The Law of Real Property,* Third Edition, 1939, Section 174.)
   (4) *Estate or Tenancy from Period to Period.* A tenancy for any fixed period which will automatically continue for subsequent successive periods until terminated, by due notice, at the end of a period. (Tiffany, *The Law of Real Property,* Third Edition, 1939, Section 167.)

c. A quitclaim deed conveys merely whatever title to the particular land the grantor may have and its use excludes any implication that he has good title; accordingly, it generally contains no covenants of title. On the other hand, a warranty deed, in addition to conveying the grantor's interest in the real

property, warrants his title thereto. Thus, a warranty deed generally contains one or more covenants, such as covenants of seisin, against incumbrances, for quiet enjoyment, etc., under which the grantee may, in case of failure of title, obtain indemnity in damages. Warranty deeds are sometimes classified as "general" and "special"; a general warranty or covenant protects the grantee against the claims of all persons whomsoever, while a special warranty affords protection against the acts of the grantor only, or of persons claiming under him. (Tiffany, *The Law of Real Property,* Third Edition, 1939, Sections 959, 999 et seq.; 44 Words and Phrases, pages 694 and 695.)

No. 11 (10 points)

1. False. (Subsection 1, Section 6, Uniform Negotiable Instruments Law.)
2. True. (Section 58, Uniform Negotiable Instruments Law.)
3. False. (Section 29, Uniform Negotiable Instruments Law.)
4. True. (Section 68, Uniform Negotiable Instruments Law.)
5. True. (Section 48, Uniform Negotiable Instruments Law.)
6. False. (Section 28, Uniform Negotiable Instruments Law.)
7. True. (Section 23, Uniform Negotiable Instruments Law.)
8. True. (Section 22, Uniform Negotiable Instruments Law.)
9. False. (Section 38, Uniform Negotiable Instruments Law.)
10. True. (Subsection 1, Section 66, and Subsection 3, Section 65, Uniform Negotiable Instruments Law.)

No. 12 (10 points)

1. False. *Williston on Contracts,* Revised Edition, 1936, Sections 99 and 107.
2. False. Op. cit. Section 115.
3. True. Op. cit. Sections 160-163.
4. False. Op. cit. Sections 130, 132, and 133.
5. False. Op. cit. Section 120.
6. (See Explanation of Answers 6 through 10 below.)
7. False.
8. True.
9. False.
10. True.

Explanation of Answers 6 through 10

As a general rule "fixtures" belong to the owner of the land to which they are attached. In deciding whether an article or structure annexed to the land is a fixture, the intention of the parties is ordinarily controlling, and the character of the article or the mode of its attachment are merely evidence bearing on intention. Where a tenant is concerned, the presumption is prima facie that the tenant did not intend to enrich the owner of the land but intended to reserve the title and right to remove the article to himself; this presumption is, however, ordinarily limited to trade and domestic fixtures. Furthermore, the right of removal cannot be exercised if the premises will be thereby substantially injured nor, according to some authorities, if the article annexed cannot be removed without losing its identity.

In the present case, the lathe, workbench, and electric motor are either removable as trade fixtures, that is, fixtures used by the tenant in carrying on his business, or removable because, by inference from their presumably portable and detachable character, they were not intended to be fixtures at all. In the case of the cement walk, the reasonable inference is that it was intended to be permanent; furthermore, it cannot be removed without losing its identity. The garage presents a more difficult problem. Buildings may be removable if they are trade fixtures; the garage, however, was apparently only partially used as a workshop. The character of the garage's foundation, which is not given in the problem, is relevant either as bearing on the tenant's intention or on the question of whether removal can be had without injuring the premises; a portable garage, for instance, has been held to be removable even though not a trade fixture (*Hanson* v. *Ryan,* 185 Wis. 566, 201 N.W. 749, 36 A.L.R. 1516).

As to the tenant's rights vis-a-vis a subsequent mortgagee of the realty, the mortgagee, if he has notice of the tenant's right of removal, takes the realty subject to that right. Although there is diversity of opinion, the majority view is that possession of the land by the lessee charges a subsequent mortgagee with notice of any title the lessee may have to buildings, improvements or other fixtures on the premises. (Tiffany, *The Law of Real Property,* Third Edition, 1939, Sections 606, 616-622; 22 American Jurisprudence, Fixtures, Section 42.)

INDEX

Accounting methods, change in 190
Accounting practice, questions in 1, 36, 67, 96, 129, 170
Accounting procedures, conservative 15
Accounts payable
  Bankruptcy, percentage of probable payments to 141
  Confirmation 24
Accounts receivable
  Confirmation, more frequent than accounts payable 24
  Mail receipts, internal control 161
Agency
  Appointment of agent 90
  Authority, termination of 32
  Authority to represent principal 90
  "Del credere" agent, define 91
  Duties of principal and agent 61, 123
  Lien, define 123
  Lien, funds or property of principal 123
  Loss of principal's funds 163
  Principal's instructions 163
  Principal's notice, third parties bound by 163
  Recovery of loss on agents' agreement 204
  Termination 163
  Terms, definitions 62
  Written instrument, relationship created by 31
Agreements
  Not to engage in practice of public accounting 34
  Not to seek similar employment 35
Amortization
  Discount and expense on bonds 137
  Straight-line method 109
Assets
  Fixed, audit 85
  Fixed, depreciation bases 185
  Fixed, minimum dollar amounts 106
  Fixed, values 134
Auditing
  Questions in 21, 54, 83, 114, 155, 191
Auditors
  Duties regarding cash 116
  Inquiries of management 86
Bad debts
  Expense as direct deduction from sales 145
Balance-sheet
  Consolidated, stock transacting on 19
  Date, events occurring subsequent to 87
  From incomplete records 36
  Items not expressed in current dollars 77
  Nature, purpose, and limitations 18
  Outline of examination 155
  Rearrangement for municipal reporting 173
Bank reconciliations
  Deposit in transit 30
  Prepare and adjust entries in journal 155
Bankruptcy
  Chattel mortgage to secure obligation 32
  Claim against bankrupt 32
  Creditors 166
  Determination of exemptions 166
  Discharge 65
  Indebtedness, minimum amount 166
  Insolvency of debtor 32
  Investigation for suspected fraud 196
  Involuntary, as distinct from voluntary, purpose 32
  Involuntary, who may not be adjudicated 166
  Payments to accounts payable, compute 140
  Preferential transfer 65
  Statement of estimated deficiency, prepare 140
  Voluntary, who may not become 166
Bill of Lading
  Kinds 33
  Nonnegotiable 120
  Refusal to accept 120
Bills of exchange, protest 201
Blue sky laws, define 202
Bond subscription, employee plan for 27
Bonds
  Accounting transactions 68
  Budget provision for annual reduction 15
  Municipal, tax treatment 175
"Bonds outstanding" method, amortization of discount and expense, computation 137
Bonus, for excess production 2
Book value
  Inventory 1
  Stock 39
Bookkeeping, double-entry
  Advantages of 15
  Incomplete records 36
Branches
  Internal-control procedure 27
  Records and statements 74
Building and loan association, Methods of distributing profits 142
By-products and joint products 184
Canadian income tax, deductibility of 175
Capitalization, excess, suggestions to take care of 150
Cash, examination 116
Cash receipts, "lapping" 54
Cash registers, effectiveness of 197
Certificate of opinion
  Disclaimer 192
  Exceptions as to scope 192
  Limitations, for investment purposes 125

INDEX

Short-form report, draft 192
Short-form report, with and without qualifications 83
Short-form report, without confirming receivables or observing inventories 114
Charitable contributions, income-tax treatment 7
Charter parties, authority of agent to charter steamship 204
Checks
Certified and noncertified, legal advantage 126
Drawn on insolvent bank 61
Invoices and documents marked "paid" 55
Clients, relation of public accountant to 123
Commercial law, questions in 29, 60, 89, 120, 163, 200
Commitments, purchase, in financial statements 108
Common carrier
Liability for damaged goods 93
Lien of shipper 120
Private, distinguished 93
Refusal to accept goods for transportation 93
Competition
Agreement not to engage in practice of public accounting 34
Agreement not to seek similar employment 35
Restrictions not to compete 91
Confirmation
Accounts payable and receivable 24
Notes payable 24
Requests to accounts receivable 160
Stock outstanding 21
Consignment of, merchandise, journal entries 152
Contingent Fees
See Professional Ethics
Contracts
Acceptance, mail or telegraph 121
Agreements not to compete 91
Avoidance 122
Breach of, general and special damages, distinguish 205
"Completed" basis 14
Damages for nonperformance 200
Executory and executed, distinguish 165
Existence of, and balance-sheet presentation 26
Express and implied, distinguish 165
Indemnity, define 205
Misrepresentation as agent 204
Misrepresentation of age 167
Mutual assent 164
Nonperformance 124
"Percentage of completion" or "Completed" basis 189
Performance, tender of 200
Promise to pay additional amount 31
Quasi, define 165
Rescission, due to error in calculation 31
Restrictions, not to compete 91
Revocation 34
Rights of buyer 90
Sale 34
Substantial performance, doctrine of 178
Suretyship, define 205
Termination of employment 35
Ultra vires 122
Corporation
Close, define 165
Domestic and foreign, difference 126
Dummies, define 165
Liability for contracts made by promoter 91
Municipal, define 125
Partnership, difference as to legal status 203
Promoter, define 91
Promoters, agreements of 126
Quasi, define 125
Records 203
Restrictions governing adoption of names 165
Tax problems, provision for income tax, tax returns 153
Treasury stock, voting 165
Cost Accounting
By-products and joint products 184
Chemical product 132
Cost of direct materials to work in process 48
Costs in comparable companies 80
Departmental cost and production reports 105
Direct labor cost basis for applying overhead 107
Direct labor to work in process 48
Indirect costs to profit and loss 48
Payrolls 197
Spoilage costs 78
Cost of goods sold, verification 191
Cumulative voting, define 64
Damages, liquidated, define 205
Debt
Partial payment 200
Payment, application of 200
Refusal to accept payment, effect of 62
Deeds
Questions on 127
Quitclaim and warranty, difference 206
Warranty, breach of 127
"Del credere" agent, define 91
Departments
Chemical products, cost transactions 132
Cost reports 105
Foundry costs 105

INDEX

Depletion
  Basis for mining 111
Deposit in transit, verification 21
Depreciation
  Annual, inclusion in budget 17
  Annual rate charged on buildings 47
  Based on replacement costs, arguments for and against 146
Depreciation
  Costs of parking lot 78
  Rates, determining 13
  Reserves, explain 52
  Roofing company 134
  Unit basis, group bases, composite basis, define 185
Direct labor
  Cost basis for overhead 107
  Work in process to 48
Directors acting individually 91
Discount
  Cash, as charge to income 175
  Unamortized bond discount and expense account 67
Dividends
  Canadian stocks, income-tax deductibility 175
  Return of capital 175
  Stock, revocation 30
Doubtful accounts, estimating amount required 145
Drafts, sight, rights, and liabilities of holder 202
Emergency facilities, amortization claim on 175
Employment
  Agreement not to seek similar employment 35
  Termination 35
Errors, in books 3
Estates: see trustees
Ethics: see Professional ethics
Excess profits tax, income method and invested capital method, computation 113
Exemptions: see Income taxes
Financial statements: see Statements
Fire loss
  Amount recoverable 166
  Book amount of inventory 1
Fixed assets: see Assets
Flood loss 134
Footnotes
  Examples of information in 49
  Necessity for, explain 49
Foreign currency, conversion into U.S. dollars 187
Formulas and processes, audit procedures 118
Fraud
  Deposit in transit 21
  In lease 34
  Internal control 161
  Investigation of bankrupt shoe store 196
  Oral promises under statute of fraud 66
Funds
  Government 81
  Municipal, accounting transactions 101
Fungible goods, define 60
Future goods, define 60
Gifts, for establishment of library 9
Good faith purchaser, define 60
Goods in transit, loss of 90
Goodwill
  Computation for prospective partnership 170
  Decrease in amount of goodwill shown on balance sheet 53
Goodwill, selling a business 50
Government funds 81
Guarantor and surety, difference 62
Guaranty, loss 89
Holder in due course: see Negotiable instruments
Holding companies and subsidiaries
  Adjusting journal entries, prepare 137
  Consolidated statement 153
  Parent and subsidiary stock transactions 19
  Reconciliation of intercompany accounts, prepare 137
Home office: see Branches
Income
  Accounting methods of reporting 190
Income statements: see Statements
Income taxes
  Accounting methods of reporting income 190
  Accrual of, calculation 51
  Corporation income taxes and tax returns 153
  Manufacturing company, compute taxes payable 177
  Partners' shares of income and credit, summary 23
  Partnership return, prepare 129
  Stock rights 40
Incomplete records, balance-sheet presentation 36
Indirect costs, profit and loss to 48
Indorsements
  Blank and special, difference 201
  Effect of types in negotiations of negotiable papers 92
Indorsers
  Liability, nonpayment by maker 126
Infant
  Contract by 62
Installments
  Notes-receivable audit program 54
  Repossessions, accounting treatment 176
  Tax returns 79
Installment basis, audit program of store selling on 54

INDEX

Insurance
  Binder, define 93
  Examination of policies 59, 116
  Fire, determine loss 1
  Life, partnership entitled to proceeds 166
  Life, presentation on balance sheet 151
  Open policy 92
  Valued policy 92
  Wager and, distinguish between 93
Interest
  Deferred, as deduction from installment note payable 109
Internal control
  Auditor, affected by 55
  Branches 28
  Deficiencies 27
  Fraud and error 161
  Mail receipts on accounts receivable 161
  Questionnaire 88
Inventory
  Audit program 58
  Book value 1
  Certificate 159
  Compute for wholesale jobber 171
  Cost or market, determination of income 45
  Cost or market, effect on usefulness of statements 45
  Costs, classes of expense items excluded 148
  Costs, exclusion of fixed overhead 148
  Finished product, accounting treatment 176
  Lifo, Fifo, disclosure of current market value 77
  Lifo, Fifo, writing down for tax purposes 175
  Physical, responsibility of accountant 117
  Physical, review, procedures, instructions 117
  Repair parts, audit of 194
  Valuation 12
  Valuation, acceptability of procedure 23
  Valuation at lower of cost or market 182
  Valuation for work in process and finished goods 43
  Valued at cost, in mining company 111
  Verification, audit procedures 191
  Written representation 159
Jobbers
  Accounting transactions 69
  Inventory 171
Joint-stock association, corporation and, difference 125
Landlord and tenant, types of tenancies 206
"Tapping of cash receipt": see Cash receipts
Lease
  Assignment of, and sublease 93
  Avoidance because of fraud 34
  Items of significance to auditor 158
  Misrepresentation in 34
  Oral, termination of 34
  Termination 93
  Treatment of various factors in financial statements 187
  Written 34
Ledger accounts 3, 72
Liabilities
  Current, items excluded 16
  Unrecorded, discovery 117
Libraries, operational statements of 9
Liens
  Agency 123
Lifo: see Inventory
Loans, savings accounts as collateral, audit program 198
Lumber, purchase and sale of 30
Machinery and equipment, audit, nature of adjustments 161
Maintenance orders, program for work to be done 195
Merger of three businesses 7
Mining, depletion and inventory problem 111
Miscellaneous reserve, accounting treatment 149
Mortgages, chattel, in bankruptcy 32
Municipal
  Audit, statements, exhibits 198
  Balance sheet, rearrangement 173
  Encumbrance accounts, purpose and operation 152
  Funds, accounting transactions 101
  Funds, kinds of 81
  General fund, list of accounts 151
  Library operations 9
  Revenue from general property taxes 151
Negotiable instruments
  Consideration for issuance 164
  Contrasted with nonnegotiable instrument 92
  Date of presentation for payment 127
  Holder in due course 64, 89
  Holder in due course, requirements 126
  Personal "nominal" and absolute "real" defenses, distinguish between 164
  Requirements to create 92
  Title of a person defective 163
  Various types, how negotiated 92
New accounts, procedures in audit of 118
Notes payable
  Audit program 114
  Confirmation 24
Notes receivable, installment, audit program 54
Options
  Dates effective 112
  Oral promises 65

INDEX

Stock, purchase of 112
Overhead, advantages and disadvantages of direct-labor-cost basis 107
Partnership
Acts binding on firm 121
Admission of partner, prepare journal entries 106
Balance sheet 69
Capital accounts 10, 68
Corporation, difference as to legal status 203
Dissolution, assets distributed 121
Dissolution, authority of partners 203
Dissolution, cash distributed, prepare schedule 172
Drawing accounts 11
General and limited partner 167
Income tax return 129
Liability for contract 201
Limited 167, 203
Profit sharing 201
Property individually owned 204
Restriction of capital contribution 167
Unanimous consent for acts 201
Payrolls
Audit 56
Controls 197
Questionnaire 55
Pensions
Payment, compute amounts 101
Petty cash: see Cash
Postings
Procedures, explain and discuss 25
Principal and agent: see Agency
Private carrier
Common, distinguish between 93
Liability for damaged goods 93
Product
By-products and joint products 184
Gross profit on 2
Production record 2
Professional ethics
Announcement of new practice 158
Contingent fees 59
Mailing service for confirmations of accounts receivable 158
Offers to employees of other accountants 158
Working papers 158
Profits
Building and loan associations, methods of distributing 142
Gross 2
Retail business, compute for prospective partnership 170
Undivided profits, explain 52
Promissory note
Indorsement in blank and special indorsement, difference 201
Payable to fictitious person, effect 201
Promoter
Agreements 126
Contract made by 91
Define 91
Proxy, voting by 30
Public utilities
Original cost 82
Rates 82
Purchase of material, internal-control procedures 27
Quasi contracts, define 165
Quasi-corporation: see Corporation
Quorum, define 91
Real-estate taxes, accrual 19
Receipt, define 205
Receivables, different titles for 46
Receivership, statement of realization and liquidation, prepare 99
Release
Define 205
Finality 205
Rent
Based on gross sales, compute 39
Minimum, treatment in statements 39
Reorganization, accounting transactions 103
Reports
Corporate fixed assets 18
Long-form, examples of information in 50
Short-form: see Certificate of opinion
Reserves
Depreciation, explain 52
Elimination on liability side of balance sheet 47
General contingency, explain 52
Retail business, audit of, for prospective partnership 170
Retained earnings, freezing by means of stock dividends 181
Returnable containers, accounting treatment for 177
Returns and allowances, purposes of a review 59
Royalties
Liability, verification 193
Payable, report on 193
"Sale on trial," define and distinguish between "sale or return" 89
"Sale or return," define and distinguish between "sale on trial" 89
Sales
Duplicate 124
Goods wholly or partially destroyed 60
On sale or return 124
Purchaser in good faith and for value 163
Schedule 74
Selling price unit 173
Unpaid seller 60
Savings accounts, as collateral 198
Securities, audit 83

INDEX

Short-form report: see Certificate of opinion
Spoilage, treatment of cost in accounts 78
Statements
  Application of funds, prepare from data 38
Statements, cash flow, prepare 97
  Conservative 15
  Consolidated, holding company and subsidiary 153
  Consolidated, limitations 188
  Consolidated, preparation 70
  Costs and production by departments 43
  Income, "all-inclusive" 77
  Income, desirability of checking 28
  Income, incomplete records 36
  Income, items not expressed in current dollars 80
  Income; nature, purpose, limitations 18
  Inventory values for work in process and finished goods 43
  Items and their effect on corporation's 131
  Realization and liquidation, prepare 99
  Source and application of funds 80
Stock
  Book value 39
  Common, option to purchase 112
  Cumulative preferred, define 63
  No-par, define 63
  Outstanding at balance-sheet date 21
  Participating preferred, define 63
  Theoretical value 40
  Transactions between parent and subsidiary 19
Stock rights, tax treatment 40
Stockholders
  As secured or unsecured creditors 29
  Outside, dollar amount of dividends, compute 142
  Outside, dollar equity in total net assets, compute 142
  Pre-emptive right of, define 64
  Rights 29
  Voting by proxy 30
Surety
  Action against 62
  And guarantor, difference 62
  Collateral given by 62
  Contract entered into by corporation, partnership 62
  Contribution from cosureties 205
  Default 89
  Recovery of debt 33
  Right of contribution, define 205
Suretyship, define 205
Surplus
  Audit 57
  Paid-in surplus, explain 52
Tax returns
  See also Income taxes
  Individual, prepare 96
Taxes, see "Excess profits tax; Income taxes; Real estate taxes
Tenancies, see Landlord and tenant
Theory of accounts, questions in 12, 45, 77, 106, 145, 182
Time cards, Internal control procedure 26
Title, negotiability 164
Title to property
  Adverse possession 206
  Purchase and sale of lumber 30
Trade-ins
  Journal entries, prepare 182
  Treatment in accounts 147
Trucking, accounting transactions 109
Trustee
  Principal and income, items charged against 52
Ultra vires
  Contract, performed in full 122
  Objection to 122
Uniform Partnership Act, acts binding on firm 121
Uniform Sales Act, purchaser in good faith and for value 163
Wager, insurance and, distinguish between 93
Wages, computation 2
Warehousemen, liability, loss of goods by fire 168
Warranty
  Breach of, by seller 200
  Indorser of bill of lading 90
  To third parties 31
Warranty deed: see Deeds
Wholesalers, confirmation requests 160
Working papers
  Manufacturing company, prepare from data 177
Worksheet, hospital, prepare from data 41
Writedowns 186
Written promises: see Contracts
Written representations, inventory 159