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Students' Department

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Students' Department

H. P. BAUMANN, *Editor*

AMERICAN INSTITUTE EXAMINATIONS

[NOTE.—The fact that these answers appear in THE JOURNAL OF ACCOUNTANCY should not cause the reader to assume that they are the official answers of the board of examiners. They represent merely the opinions of the editor of the *Students' Department*.]

EXAMINATION IN ACCOUNTING THEORY AND PRACTICE—PART II

May 18, 1934, 1:30 P. M. to 6:30 P. M.

Solve problems 1, 2, 3 and 4 and two of the three problems, 5, 6, 7

No. 3 (15 points):

Compute the federal income tax of Simon Marks, retailer, for the calendar year 1933. His income and expenses for the year were as follows:

Sales	\$91,000
Dividends received	870
Profit on sales of real estate, securities, etc.	2,000
Interest received	900
Purchases	\$74,000
Salaries paid	10,400
Rent	3,000
Light	1,200
Donations	280
Interest paid	1,650
Advertising	1,350
Taxes and licences	520
Delivery expense	600

Upon inquiry, you learn the following:

- (a) The inventory of goods on hand at January 1, 1933, was \$21,000, and at December 31, 1933, was \$18,500.
- (b) The dividends were received from the following sources:

Domestic corporations which are not exempt from the income tax	\$570
Foreign corporations	300
Total	<u>\$870</u>

The dividends declared by the domestic corporations on Mr. Marks' stock were \$600. However, he received only \$570. The remaining \$30 were deducted and withheld by the payor corporations as the federal tax on dividends.

- (c) The interest received consisted of:
- | | |
|--|-----------------|
| Board of education, city of Chicago bonds | \$212.50 |
| Federal farm loan bonds | 225.00 |
| Foreign government bonds | 212.50 |
| Bonds containing a 2% tax-free covenant clause | 250.00 |
| Total | <u>\$900.00</u> |

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- (d) The salaries paid included a salary of \$5,200 paid to Simon Marks.
- (e) The donations consisted of the following:
- | | |
|--|--------------|
| Community chest | \$ 50 |
| Democratic committee | 100 |
| The Crusaders | 10 |
| Salvation Army | 10 |
| Red Cross | 25 |
| An indigent relative | 25 |
| Christmas bonus to employees | 60 |
| Total | <u>\$280</u> |
- (f) The taxes and licences paid were as follows:
- | | |
|--|--------------|
| Personal property tax | \$ 50 |
| Retailers' licence | 100 |
| Street-improvement tax | 100 |
| Real-estate tax on residence | 210 |
| Automobile licences | 20 |
| Federal cheque tax | 20 |
| Tax on club dues | 20 |
| Total | <u>\$520</u> |
- (g) The profits from sales of securities, grain, etc., were as follows:
- | | |
|---|----------------|
| Profit from sale of grain | \$ 2,000 |
| Profit from sale of unimproved real estate | 2,000 |
| Total profit | <u>\$4,000</u> |
| Loss from sale of securities which were owned less than two years
at time of sale: | |
| Foreign government bonds | \$1,000 |
| Stock of domestic corporations | 1,000 |
| | <u>2,000</u> |
| Net profit | <u>\$2,000</u> |
- (h) Mr. Marks was married and living with his wife and had two dependent children under 18 years of age throughout the entire year.

Solution:

Income:

Income from business—schedule A	\$1,320.00	
Interest on tax free covenant bonds	250.00	
Interest on foreign government bonds	212.50	
Profit on sale of capital assets (schedule B)	3,000.00	
Dividends on domestic corporations	600.00	
Dividends on foreign corporations	300.00	<u>\$5,682.50</u>

Deductions:

Taxes paid:

Personal property	\$ 50.00	
Real-estate	210.00	
Automobile licences	20.00	
Tax on club dues	20.00	
Tax on dividends	30.00	<u>\$ 330.00</u>
Contributions	85.00	<u>415.00</u>
Net income		<u>\$5,267.50</u>

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Credits:			
Dividends (subject to surtax only).....	\$600.00		
Personal exemption.....	2,500.00		
Credit for dependents.....	800.00		3,900.00
		<hr/>	
Net income subject to normal tax.....			<u>\$1,367.50</u>

Tax:			
4% of \$1,367.50.....	\$54.70		
Less: income tax paid at source (2% of \$250.00).....	5.00		
		<hr/>	
Tax payable.....	<u>\$49.70</u>		

Regarding contributions, section 23 of the act of 1932 says in part: "in computing net income there shall be allowed as deductions: . . .

"(n) . . . In the case of an individual, contributions or gifts made within the taxable year to or for the use of: . . .

"(2) a corporation, or trust, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual."

Under this section, the following are deductible:

Community chest.....	\$50.00	
Salvation army.....	10.00	
Red cross.....	25.00	
		<hr/>
Total.....	<u>\$85.00</u>	

The payment to the individual (indigent relative) of \$25 is not deductible.

Article 262, regulations 77 says in part: "Sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income."

Under this section, the payments to the following are not deductible:

Democratic committee.....	\$100.00	
The Crusaders.....	10.00	
		<hr/>
Total.....	<u>\$110.00</u>	

The Christmas bonus to employees of \$60 should be considered as extra compensation to the employees and is, therefore, deductible. (See I. T. 1600; C. B. June 1923, p. 184.)

Street-improvement tax of \$100 is considered as a capital expenditure and is not deductible for tax purposes. The tax on dividends (\$30) withheld by payor corporations is added back to the net amount of dividends received, and is deducted as a tax.

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Schedule A
Income from business

Sales.....		\$91,000.00
Cost of sales:		
Inventory, January 1, 1932.....	\$21,000.00	
Purchases.....	<u>74,000.00</u>	
Total.....	\$95,000.00	
Less: inventory, December 31, 1933.....	<u>18,500.00</u>	<u>76,500.00</u>
Gross profit.....		\$14,500.00
Less: deductible expenses:		
Salaries paid (exclusive of salary paid to Mr. Marks).....	\$ 5,200.00	
Additional compensation.....	60.00	
Rent.....	3,000.00	
Light.....	1,200.00	
Interest paid.....	1,650.00	
Advertising.....	1,350.00	
Delivery expense.....	600.00	
Retailers' licence.....	100.00	
Federal cheque tax.....	<u>20.00</u>	<u>13,180.00</u>
Net income from business.....		<u>\$ 1,320.00</u>

Schedule B
Profit on sale of capital assets

Profit from sale of grain.....	\$2,000.00
Profit from sale of unimproved real estate.....	<u>2,000.00</u>
Total profit.....	\$4,000.00
Loss from sale of foreign government bonds.....	<u>1,000.00</u>
Net profit.....	<u>\$3,000.00</u>

NOTE.—Section 23 (r) of the act of 1932 states, in part: “(1) Losses from sales or exchanges of stocks and bonds (as defined in sub-section (t) of this section) which are not capital assets (as defined in section 101) shall be allowed only to the extent of the gains from such sales or exchanges.” Sub-section (t) defines stocks and bonds but specifically excludes those of a government or political subdivision thereof. Section 101 defines capital assets as those which were held for more than two years. Hence, in this problem, the profit on the sale of grain and unimproved real estate may be reduced by the loss on the sale of the government bonds, and not by the loss on the stock of the domestic corporations, which stock was held for less than two years. This latter loss may be deducted only from profits arising from the sale of stocks and bonds as defined in section 23 (t) held for less than two years.

No. 4 (15 points):

Charles Black & Co., a corporation, had a factory whose output was absorbed by two customers.

The president and the treasurer each signed cheques, only one signature being necessary. The president bought the raw materials and supplies. The

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treasurer kept the books, handled the receipts and drew the cheques. Incidentally, he was also receiving teller in one of the local banks patronized by the company.

The accounts of Charles Black & Co. had never been audited until the president demanded an audit which developed at once into an investigation.

All the paid cheques returned by the banks were on hand and available to the auditor, and the cheques received from the two customers were produced on request. After a brief examination of the latter, inquiries revealed that the treasurer had a personal account in his own bank and another in a large bank in an adjacent city.

It was found that \$65,000 of customers' cheques had not been credited to them nor entered anywhere on the books (except \$10,000 mentioned below). The treasurer had endorsed the cheques for the company in blank in his own handwriting and used them himself by passing them through bank accounts other than those of the company, as evidenced by later endorsements.

There were cheques aggregating \$25,000, which had been credited to customers' ledger accounts but not entered in the cashbook nor deposited in the company's bank account. These were similarly endorsed and used.

Cash sales of old machinery and scrap amounting to \$1,200 had been made and entered, but the proceeds were retained by the treasurer.

A mortgage was placed on the factory for \$10,000 and the company received the money in two instalments of \$5,000 each. The full amount was entered in the cashbook as received and credited to mortgage account in the ledger, but only \$5,000 was placed in the bank. The other \$5,000 was taken by the treasurer, for which he gave his note. An entry crediting cash and charging notes receivable was made by him. Several months later he discounted at the bank a company note for \$5,000 to the credit of the company, charging cash as if coming from him and crediting notes receivable. He destroyed his own note. When the company's note was due the bank charged it to the company, but no entry whatsoever was made on the books. The treasurer destroyed this note also. The president of the company knew of the mortgage but denied all knowledge of the notes.

Later another \$10,000 was borrowed on the mortgage, but no entry was made on the books. The treasurer turned this money to his own uses. About a month later one customer's cheque for \$10,000, as above mentioned, was credited to the mortgage account instead of being credited to the customer.

On the other hand, \$30,000 in all was deposited in the bank at various dates to the credit of the company by the treasurer himself, without entry on the books.

Payments to creditors and for salaries and wages and other expenses for the past year, by quarters, aggregated as follows:

	Per cash book	Per cheque book stub	Per cheques
Accounts payable—1st quarter	\$ 3,225	\$ 2,525	\$ 1,725
" " 2nd "	3,000	2,500	2,000
" " 3rd "	8,250	7,250	6,250
" " 4th "	4,800	4,300	3,500
	\$19,275		\$13,475
Cash for salaries, wages, etc.:			
" " " 1st quarter	3,100	3,500	4,100
" " " 2nd "	5,600	5,600	6,600
" " " 3rd "	1,500	2,000	2,500
" " " 4th "	2,700	4,500	5,500
	\$32,175	\$32,175	\$32,175

All correspondence from creditors relative to short payments had been suppressed by the treasurer.

If the candidate finds any evidence of shortage in the figures next above he may consider them part of the defalcation.

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Prepare a statement showing briefly the several items making up the total defalcation. Disregard interest. No journal entries are wanted.

Solution:

Statement showing the details of the defalcation of the treasurer of Charles Black & Co.

Receipts appropriated by the treasurer:	
Customers' cheques, not entered, nor deposited.....	\$ 55,000
Customers' cheques, entered, but not deposited.....	25,000
Cash proceeds from sales of old machinery.....	1,200
Company's note issued; proceeds applied against treasurer's note given to the company.....	5,000
Proceeds from additional loan on mortgage.....	10,000
Cheques issued to cash in excess of payrolls, etc.....	5,800
Total.....	\$102,000
<i>Less:</i> amounts deposited in the bank to the company's credit, but not recorded.....	30,000
Net amount of defalcation.....	\$ 72,000

No. 5 (12 points):

From the following balance-sheets of the R Company and other information given below prepare a statement of resources and their application in the year 1933:

BALANCE-SHEETS OF THE R COMPANY

<i>Assets</i>	December 31, 1932	December 31, 1933
Land and buildings.....	\$ 450,000	\$ 750,000
Machinery.....	200,000	400,000
Tools.....	40,000	80,000
Goodwill.....	200,000	230,000
Investments.....	95,000	
Inventories.....	400,000	375,000
Accounts receivable.....	175,000	250,000
Unexpired insurance.....	3,000	4,000
Cash.....	25,000	20,000
	\$1,588,000	\$2,109,000
<i>Liabilities</i>		
Capital stock.....	\$ 800,000	\$1,100,000
Bonds.....	350,000	500,000
Notes payable.....	70,000	80,000
Accounts payable.....	145,000	125,000
Accrued interest.....	7,000	11,000
Accrued taxes.....	4,000	6,000
Surplus.....	212,000	287,000
	\$1,588,000	\$2,109,000

During the year a dividend of 4 per cent. was declared and paid on the stock outstanding at the beginning of the year. Seven thousand dollars was provided for the depreciation of the buildings; \$16,000 for machinery and \$4,000 for tools. The bonds were sold at par, the stock was sold at 90 and the difference was charged to goodwill account.

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Solution:

Schedule 1

R COMPANY				
Statement of working capital and prepaid expenses				
December 31,				
	1932	1933	Increase	Decrease
Current assets:				
Inventories.....	\$400,000	\$375,000		\$25,000
Accounts receivable.....	175,000	250,000	\$75,000	
Cash.....	25,000	20,000		5,000
	<u>\$600,000</u>	<u>\$645,000</u>		
Current liabilities:				
Notes payable.....	\$ 70,000	\$ 80,000		10,000
Accounts payable.....	145,000	125,000	20,000	
Accrued interest.....	7,000	11,000		4,000
Accrued taxes.....	4,000	6,000		2,000
	<u>\$226,000</u>	<u>\$222,000</u>		
Working capital.....	<u>\$374,000</u>	<u>\$423,000</u>		
Unexpired insurance.....	<u>\$ 3,000</u>	<u>\$ 4,000</u>	1,000	
Increase in working capital and prepaid expenses.....				<u>50,000</u>
Totals.....			<u>\$96,000</u>	<u>\$96,000</u>

R COMPANY

Statement of application of funds for the year ended December 31, 1933

Funds provided:

By profits:

Net profit, per books.....	\$107,000		
Add charges to profit and loss, not requiring funds:			
Depreciation—buildings.....	\$ 7,000		
Depreciation—machinery.....	16,000		
Depreciation—tools.....	4,000	27,000	\$134,000
		<u>27,000</u>	

By sale of capital stock:

Par value.....	\$300,000		
Less: discount charged to goodwill.....	30,000		270,000
By sale of bonds of R Company.....			150,000
By sale of investments.....			95,000
			<u>150,000</u>

Total funds provided.....			<u>\$649,000</u>
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		R COMPANY									
		Application of funds—working papers									
		December 31,		Year's excess		Adjustments		Working capital		Funds	
	1932	1933	Debit	Credit	Debit	Credit	Increase	Decrease	Applied	Provided	
<i>Assets</i>											
Land and buildings	\$ 450,000	\$ 750,000	\$300,000		\$ 7,000				\$307,000		
Machinery	200,000	400,000	200,000		16,000				216,000		
Tools	40,000	80,000	40,000		4,000				44,000		
Goodwill	200,000	230,000	30,000								
Investments	95,000			\$ 95,000		(e) \$ 30,000				\$ 95,000	
Inventories	400,000	375,000		25,000				\$25,000			
Accounts receivable	175,000	250,000	75,000					\$75,000			
Unexpired insurance	3,000	4,000	1,000					1,000			
Cash	25,000	20,000		5,000				5,000			
	<u>\$1,588,000</u>	<u>\$2,109,000</u>									
<i>Liabilities and capital</i>											
Capital stock	\$ 800,000	\$1,100,000		300,000 (e)	30,000					270,000	
Bonds	350,000	500,000		150,000						150,000	
Notes payable	70,000	80,000		10,000				10,000			
Accounts payable	145,000	125,000	20,000				20,000				
Accrued interest	7,000	11,000		4,000				4,000			
Accrued taxes	4,000	6,000		2,000				2,000			
Surplus	212,000	287,000		75,000 (f)	107,000 (a)	32,000					
	<u>\$1,588,000</u>	<u>\$2,109,000</u>		<u>\$666,000</u>							
Cash dividends paid									32,000		
Depreciation written off:											
Buildings										7,000	
Machinery										16,000	
Tools										4,000	
Net profit for the year										107,000	
Increase in working capital								50,000	50,000		
									<u>\$649,000</u>	<u>\$649,000</u>	

NOTE.—These working papers are not required by the examiners in solving this problem, and are presented here for explanatory purposes only.

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Funds applied:

To purchase of fixed assets:			
Land and buildings.....	\$307,000		
Machinery.....	216,000		
Tools.....	44,000	\$567,000	
To payment of dividend (4%).....		32,000	
To increase in working capital and prepaid expenses (schedule 1).....		50,000	
Total funds applied.....		\$649,000	

No. 6 (12 points):

A machine costing \$256 is estimated to have a life of four years, with a residual value of \$16.

Prepare a statement showing the annual charge for depreciation according to each of the following methods: (a) straight line; (b) constant percentage of diminishing value; (c) annuity method.

Assume the rate of interest to be 10%.

Solution:

The symbols used in the formulae of the solution follow:

D = Annual depreciation charged

C = Cost (\$256)

S = Residual value (\$16)

n = Number of periods (four years)

p = Present value of \$1 due 4 years hence at 10%

P = Present value of an annuity of 1 for 4 years at 10%

(a) the formula for computing the annual charge for depreciation by the straight line method is:

$$D = \frac{C - S}{n}$$

Applying the data given in the problem, we have

$$D = \frac{\$256 - \$16}{4} \text{ or } \$60$$

Table of depreciation—straight line method

End of year	Depreciation	Accumulated depreciation reserve	Carrying value
1.....	\$60.00	\$ 60.00	196.00
2.....	60.00	120.00	136.00
3.....	60.00	180.00	76.00
4.....	60.00	240.00	16.00

(b) The formula for computing the rate of depreciation by the "constant percentage of diminishing value" method is:

$$r = 1 - \sqrt[n]{S \div C}$$

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Applying the data given in the problem, we have

$$r = 1 - \sqrt[4]{\frac{\$16}{\$256}} \text{ or } 1 - \frac{2}{4} \text{ or } 50\%$$

Table of depreciation—uniform rate on diminishing value (rate 50%)

Year	Depreciation	Accumulated depreciation reserve	Carrying value
1.....	\$128.00	\$128.00	\$256.00
2.....	64.00	192.00	64.00
3.....	32.00	224.00	32.00
4.....	16.00	240.00	16.00

(c) The formula for computing the annual charge for depreciation by the annuity method is:

$$D = \frac{C - (S \times p)}{P}$$

The computations to ascertain the present value of \$1 for 4 years at 10 per cent., and the present value of an annuity of 1 for 4 years at 10 per cent. follow:

1.10
1.10
—
1.21
1.10
—
1.331
1.10
—

1.4641 = the amount of 1 for 4 years at 10%
1 ÷ 1.4641 = .683, the present value of 1 for 4 years at 10%
1 - .683 = .317, the compound discount
.317 ÷ .10 = 3.17, the present value of an annuity of 1 for 4 years at 10%

Applying these present values and the data given in the problem, we have

$$D = \frac{\$256.00 - (\$16.00 \times .683)}{3.17}, \text{ or } \frac{\$256.00 - \$10.93}{3.17}, \text{ or } \$77.31$$

Table of depreciation—annuity method

Year	Depreciation	Interest credits	Accumulated depreciation reserve	Carrying value
1.....	\$77.31	\$25.60	\$51.71	204.29
2.....	77.31	20.43	56.88	147.41
3.....	77.31	14.74	62.57	84.84
4.....	77.31	8.48	68.83	16.01

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No. 7 (12 points):

The H. Manufacturing Company has been losing money for several years and intends to reorganize.

From the following list of accounts as at December 31, 1933, and other information given below prepare a statement of affairs also showing the amounts that will be realized and the estimated losses on realization:

Advances to employees	\$ 2,657.44
Cash	4,204.67
Creditors	104,231.33
Creditors, preferred	1,716.20
Customers	200,676.93
Capital stock, common	200,000.00
Capital stock, preferred	150,000.00
Capital stock subscriptions	96,400.00
Deficit	133,893.43
Furniture and fixtures	9,197.26
Goodwill	75,000.00
Inventories	75,693.07
Notes payable	189,663.51
Notes receivable	11,462.50
Plant and machinery	33,860.49
Real estate	2,565.25

The original capital stock was \$150,000 preferred and \$100,000 common, which was fully paid. The subsequent authorized increase of \$100,000 common stock is unpaid, except \$3,600. The remaining \$96,400 is due from wholly insolvent subscribers. The company has assigned \$24,072.08 of its customers' accounts, worth their face value, to one of its creditors and estimates that it still has an equity in them of \$2,661.81, although this fact does not appear on the books. Of the remaining customers' accounts \$46,706.00 are barred by the statute of limitations and \$36,584.03 are more than doubtful. The remaining assets are estimated to be worth as follows:

Inventories	\$ 9,996.42
Plant and machinery	22,088.38
Real estate	1,830.25
Furniture and fixtures	6,697.26
Notes receivable	9,823.40

Solution:

(See statement on next page)

THE H. MANUFACTURING COMPANY
Deficiency account—December 31, 1933

Estimated loss on:	Capital stock:
Advances to employees \$ 2,657.44	Preferred \$150,000.00
Customers:	Common 200,000.00
Barred by statute . . 46,706.00	Deficiency to creditors.. 123,583.76
Uncollectible 36,584.03	
Capital stock subscrip- tions 96,400.00	
Furniture and fixtures 2,500.00	
Goodwill 75,000.00	
Inventories 65,696.65	
Notes receivable 1,639.10	
Plant and machinery . 11,772.11	
Real estate 735.00	
Deficit 133,893.43	
\$473,583.76	\$473,583.76

