1993

Uniform CPA examination, May 1988-May 1992. Selected questions and unofficial answers indexed to content specification outline

American Institute of Certified Public Accountants. Board of Examiners

American Institute of Certified Public Accountants. Examinations Division

Uniform CPA Examination
May 1988-May 1992

Selected Questions & Unofficial Answers

AICPA

Also Includes Complete Text of November 1992 Uniform CPA Examination Questions & Unofficial Answers

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FOREWORD

The Uniform CPA Examination is prepared by the Board of Examiners of the American Institute of Certified Public Accountants, and is used by the examining boards of all fifty states of the United States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands as a prerequisite for issuance of CPA certificates.

This book contains selected questions and unofficial answers from the nine Uniform Certified Public Accountant Examinations from May 1992 back to May 1988. The questions and unofficial answers have been indexed in accordance with the Content Specification Outlines for the Uniform Certified Public Accountant Examination.

All questions are identified by a boldface code indicating the month—May (**M**) or November (**N**); the year (**88** through **92**); and the question number in the original examination. Within the content specification areas and groups, questions and answers have been arranged in reverse chronological order.

Each individual multiple choice question is indexed according to the area and group it tests. In some cases, a common fact pattern is used for two or more multiple choice questions. In such cases, where different areas and groups are being tested by questions referring to a common fact pattern, the fact pattern is repeated to accompany the questions indexed in each applicable area or group.

Each other objective answer format question is indexed according to the area it tests and in certain cases to the group it tests. Where an other objective answer format question and its answer involve more than one area, they have been separated and indexed according to areas tested. Thus, all parts of a question and its answer may not appear in their original examination sequence.

Each essay question is indexed according to the area it tests and in certain cases to the group it tests. Where an essay question and its answer involve more than one part—for example, part a. and part b.—they have been separated and indexed according to areas and groups tested. Thus, all parts of a question and its answer may not appear in their original examination sequence.

In addition to the selected questions and unofficial answers, all of the questions and unofficial answers from the November 1992 Uniform CPA Examination are included at the end of the book. Following the November 1992 exam's questions and unofficial answers is an index of the exam's questions that classifies them in accordance with each section's Content Specification Outline.

Although the questions and unofficial answers may be used for many purposes, the principal reason for their publication is to aid candidates in preparing to take the examination. Candidates are also encouraged to read *Information for CPA Candidates*, which describes the content, grading, and other administrative aspects of the Uniform CPA Examination.

The unofficial answers were prepared by the staff of the Examinations Division and reviewed by the Board of Examiners but are not purported to be official positions of the American Institute of Certified Public Accountants.

Rick Elam, *Vice President—Education*
American Institute of Certified Public Accountants

January 1993

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Accounting Practice

Selected Questions And Unofficial Answers Indexed To Content Specification Outline

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†Questions in this area are not classified according to group.

MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1N91#1. Gar, Inc.'s trial balance reflected the following liability account balances at December 31, 1990:

Accounts payable	$19,000
Bonds payable, due 1991	34,000
Deferred income tax payable	4,000
Discount on bonds payable	2,000
Dividends payable on 2/15/91	5,000
Income tax payable	9,000
Notes payable, due 1/19/92	6,000

The deferred income tax payable is based on temporary differences that will reverse in 1992 and 1993.

In Gar's December 31, 1990, balance sheet, the current liabilities total was

a. $71,000
b. $69,000
c. $67,000
d. $65,000

1M91#1. When preparing a draft of its 1990 balance sheet, Mont, Inc. reported net assets totaling $875,000. Included in the asset section of the balance sheet were the following:

Treasury stock of Mont, Inc. at cost, which approximates market value on December 31	$24,000
Idle machinery	11,200
Cash surrender value of life insurance on corporate executives	13,700
Allowance for decline in market value of noncurrent equity investments	8,400

At what amount should Mont's net assets be reported in the December 31, 1990, balance sheet?

a. $851,000
b. $850,100
c. $842,600
d. $834,500

1M91#2. Mirr, Inc. was incorporated on January 1, 1990, with proceeds from the issuance of $750,000 in stock and borrowed funds of $110,000. During the first year of operations, revenues from sales and consulting amounted to $82,000, and operating costs and expenses totaled $64,000. On December 15, Mirr declared a $3,000 cash dividend, payable to stockholders on January 15, 1991. No additional activities affected owners' equity in 1990. Mirr's liabilities increased to $120,000 by December 31, 1990. On Mirr's December 31, 1990, balance sheet, total assets should be reported at

a. $885,000
b. $882,000
c. $878,000
d. $875,000

1M89#1. Rogo Corp.'s trial balance reflected the following account balances at December 31, 1988:

Accounts receivable (net)	$16,000
Short-term investments	5,000
Accumulated depreciation on equipment and furniture	15,000
Cash	11,000
Inventory of merchandise	30,000
Equipment and furniture	25,000
Patent	4,000
Prepaid expenses	1,000
Land held for future business site	18,000

In Rogo Corp.'s December 31, 1988 balance sheet, the current assets total is

a. $81,000
b. $73,000
c. $67,000
d. $63,000

1M89
Items 2 through 4 are based on the following:

The following trial balance of Shaw Corp. at December 31, 1988 has been adjusted except for income tax expense.

Shaw Corp.
TRIAL BALANCE
December 31, 1988

	Dr.	*Cr.*
Cash	$ 675,000	
Accounts receivable (net)	2,695,000	
Inventory	2,185,000	
Property, plant and equipment (net)	7,366,000	
Accounts payable and accrued liabilities		$ 1,801,000
Income tax payable		654,000
Deferred income tax liability		85,000
Common stock		2,300,000
Additional paid-in capital		3,680,000
Retained earnings, 1/1/88		3,350,000
Net sales and other revenues		13,360,000
Costs and expenses	11,180,000	
Income tax expense	1,129,000	
	$25,230,000	$25,230,000

Other financial data for the year ended December 31, 1988:

Included in accounts receivable is $1,000,000 due from a customer and payable in quarterly installments of $125,000. The last payment is due December 30, 1990.

The balance in the deferred income tax liability account pertains to a temporary difference that arose in a prior year, of which $15,000 is expected to be paid in 1989. Shaw elected to apply the provisions of FASB Statement No. 96, *Accounting for Income Taxes,* in its financial statements for the year ended December 31, 1988.

During the year, estimated tax payments of $475,000 were charged to income tax expense. The current and future tax rate on all types of income is 30%.
In Shaw's December 31, 1988 balance sheet,

2. The current assets total is
   a. $6,030,000
   b. $5,555,000
   c. $5,530,000
   d. $5,055,000

3. The current liabilities total is
   a. $1,995,000
   b. $2,065,000
   c. $2,470,000
   d. $2,540,000

4. The final retained earnings balance is
   a. $4,401,000
   b. $4,486,000
   c. $4,876,000
   d. $5,055,000

B. Income Statement

1M91#3. In Baer Food Co.'s 1990 single-step income statement, the section titled "Revenues" consisted of the following:

Net sales revenue		$187,000
Results from discontinued operations:		
Loss from operations of segment (net of $1,200 tax effect)	$(2,400)	
Gain on disposal of segment (net of $7,200 tax effect)	14,400	12,000
Interest revenue		10,200
Gain on sale of equipment		4,700
Cumulative change in 1988 and 1989 income due to change in depreciation method (net of $750 tax effect)		1,500
Total revenues		$215,400

In the revenues section of the 1990 income statement, Baer Food should have reported total revenues of
   a. $216,300
   b. $215,400
   c. $203,700
   d. $201,900

1M91#5. Thorpe Co.'s income statement for the year ended December 31, 1990, reported net income of $74,100. The auditor raised questions about the following amounts that had been included in net income:

Unrealized loss on decline in market value of noncurrent investments in stock	$(5,400)
Gain on early retirement of bonds payable (net of $11,000 tax effect)	22,000
Adjustment to profits of prior years for errors in depreciation (net of $3,750 tax effect)	(7,500)
Loss from fire (net of $7,000 tax effect)	(14,000)

The loss from the fire was an infrequent but not unusual occurrence in Thorpe's line of business. Thorpe's December 31, 1990, income statement should report net income of
   a. $65,000
   b. $66,100
   c. $81,600
   d. $87,000

1N89
Items 1 and 2 are based on the following:

Coffey Corp.'s trial balance of income statement accounts for the year ended December 31, 1988 was as follows:

	Debit	*Credit*
Net sales		$1,600,000
Cost of goods sold	$ 960,000	
Selling expenses	235,000	
Administrative expenses	150,000	
Interest expense	25,000	
Adjustment due to accounting change in depreciation method	40,000	
Gain on debt extinguishment		10,000
Totals	$1,410,000	$1,610,000

Coffey's income tax rate is 30%. Coffey prepares a multiple-step income statement for 1988.

1. Income from operations before income tax is
   a. $190,000
   b. $200,000
   c. $230,000
   d. $240,000

2. Net income is
   a. $140,000
   b. $161,000
   c. $168,000
   d. $200,000

1N88
Items 7 through 9 are based on the following:

Karl Corp.'s trial balance of income statement accounts for the year ended December 31, 1987 included the following:

	Debit	*Credit*
Sales		$150,000
Cost of sales	$ 60,000	
Administrative expenses	15,000	
Loss on sale of equipment	9,000	
Commissions to salespersons	10,000	
Interest revenue		5,000
Freight out	3,000	
Loss on early retirement of long-term debt	10,000	
Bad debt expense	3,000	
Totals	$110,000	$155,000

Other information

Finished goods inventory:	
January 1, 1987	$100,000
December 31, 1987	$ 90,000
Karl's income tax rate is 30%.	

On Karl's multiple-step income statement for 1987,

7. Cost of goods manufactured is
   a. $73,000
   b. $70,000
   c. $53,000
   d. $50,000

8. Income before extraordinary item is
   a. $55,000
   b. $45,000
   c. $38,500
   d. $31,500

9. Extraordinary loss is
   a. $ 7,000
   b. $10,000
   c. $13,300
   d. $19,000

C. Statement of Cash Flows

1N91
Items 5 through 7 are based on the following:

The differences in Beal, Inc.'s balance sheet accounts at December 31, 1990 and 1989, are presented below:

	Increase (Decrease)
Assets	
Cash and cash equivalents	$ 120,000
Short-term investments	300,000
Accounts receivable, net	—
Inventory	80,000
Long-term investments	(100,000)
Plant assets	700,000
Accumulated depreciation	—
	$1,100,000
Liabilities and Stockholders' Equity	
Accounts payable and accrued liabilities	$ (5,000)
Dividends payable	160,000
Short-term bank debt	325,000
Long-term debt	110,000
Common stock, $10 par	100,000
Additional paid-in capital	120,000
Retained earnings	290,000
	$1,100,000

The following additional information relates to 1990:

- Net income was $790,000.
- Cash dividends of $500,000 were declared.
- A building costing $600,000 and having a carrying amount of $350,000 was sold for $350,000.
- Equipment costing $110,000 was acquired through issuance of long-term debt.
- A long-term investment was sold for $135,000. There were no other transactions affecting long-term investments.
- 10,000 shares of common stock were issued for $22 a share.

In Beal's 1990 statement of cash flows,

5. Net cash provided by operating activities was
   a. $1,160,000
   b. $1,040,000
   c. $ 920,000
   d. $ 705,000

6. Net cash used in investing activities was
   a. $1,005,000
   b. $1,190,000
   c. $1,275,000
   d. $1,600,000

7. Net cash provided by financing activities was
   a. $ 20,000
   b. $ 45,000
   c. $150,000
   d. $205,000

1M91#4. In 1990, a tornado completely destroyed a building belonging to Holland Corp. The building cost $100,000 and had accumulated depreciation of $48,000 at the time of the loss. Holland received a cash settlement from the insurance company and reported an extraordinary loss of $21,000. In Holland's 1990 cash flow statement, the net change reported in the cash flows from investing activities section should be a

a. $10,000 increase.
b. $21,000 decrease.
c. $31,000 increase.
d. $52,000 decrease.

1M91#6. Metro, Inc. reported net income of $150,000 for 1990. Changes occurred in several balance sheet accounts during 1990 as follows:

Investment in Videogold, Inc. stock, carried on the equity basis	$5,500 increase
Accumulated depreciation, caused by major repair to projection equipment	2,100 decrease
Premium on bonds payable	1,400 decrease
Deferred income tax liability (long-term)	1,800 increase

In Metro's 1990 cash flow statement, the reported net cash provided by operating activities should be

a. $150,400
b. $148,300
c. $144,900
d. $142,800

1M91#8. The following information was taken from the 1990 financial statements of Planet Corp.:

Accounts receivable, January 1, 1990	$ 21,600
Accounts receivable, December 31, 1990	30,400
Sales on account and cash sales	438,000
Uncollectible accounts	1,000

No accounts receivable were written off or recovered during the year.

If the direct method is used in the 1990 statement of cash flows, Planet should report cash collected from customers as

a. $447,800
b. $446,800
c. $429,200
d. $428,200

1M91#9. Kresley Co. has provided the following 1990 current account balances for the preparation of the annual statement of cash flows:

	January 1	*December 31*
Accounts receivable	$11,500	$14,500
Allowance for uncollectible accounts	400	500
Prepaid rent expense	6,200	4,100
Accounts payable	9,700	11,200

Kresley's 1990 net income is $75,000. Net cash provided by operating activities in the statement of cash flows should be

a. $72,700
b. $74,300
c. $75,500
d. $75,700

1M91#10. During 1990, Teb, Inc. had the following activities related to its financial operations:

Payment for the early retirement of long-term bonds payable (carrying value $740,000)	$750,000
Distribution in 1990 of cash dividend declared in 1989 to preferred shareholders	62,000
Carrying value of convertible preferred stock in Teb, converted into common shares	120,000
Proceeds from sale of treasury stock (carrying value at cost, $86,000)	95,000

In Teb's 1990 statement of cash flows, net cash used in financing activities should be

a. $717,000
b. $716,000
c. $597,000
d. $535,000

1M91#11. Alp, Inc. had the following activities during 1990:

- Acquired 2,000 shares of stock in Maybel, Inc. for $26,000.
- Sold an investment in Rate Motors for $35,000 when the carrying value was $33,000.
- Acquired a $50,000, 4-year certificate of deposit from a bank. (During the year, interest of $3,750 was paid to Alp.)
- Collected dividends of $1,200 on stock investments.

In Alp's 1990 statement of cash flows, net cash used in investing activities should be

a. $37,250
b. $38,050
c. $39,800
d. $41,000

1M89
Items 5 through 7 are based on the following:

Dice Corp.'s balance sheet accounts as of December 31, 1988 and 1987 and information relating to 1988 activities are presented below.

	December 31, 1988	1987
Assets		
Cash	$ 230,000	$ 100,000
Short-term investments	300,000	—
Accounts receivable (net)	510,000	510,000
Inventory	680,000	600,000
Long-term investments	200,000	300,000
Plant assets	1,700,000	1,000,000
Accumulated depreciation	(450,000)	(450,000)
Goodwill	90,000	100,000
Total assets	$3,260,000	$2,160,000
Liabilities and Stockholders' Equity		
Accounts payable and accrued liabilities	$ 825,000	$ 720,000
Short-term debt	325,000	—
Common stock $10 par	800,000	700,000
Additional paid-in capital	370,000	250,000
Retained earnings	940,000	490,000
Total liabilities and stockholders' equity	$3,260,000	$2,160,000

Information relating to 1988 activities

- Net income for 1988 was $690,000.
- Cash dividends of $240,000 were declared and paid in 1988.
- Equipment costing $400,000 and having a carrying amount of $150,000 was sold in 1988 for $150,000.
- A long-term investment was sold in 1988 for $135,000. There were no other transactions affecting long-term investments in 1988.
- 10,000 shares of common stock were issued in 1988 for $22 a share.
- Short-term investments consist of treasury bills maturing on 6/30/89.

5. Net cash provided by Dice's 1988 operating activities was

a. $690,000
b. $915,000
c. $940,000
d. $950,000

6. Net cash used in Dice's 1988 investing activities was

a. $1,115,000
b. $ 895,000
c. $ 865,000
d. $ 815,000

7. Net cash provided by Dice's 1988 financing activities was

a. $305,000
b. $440,000
c. $455,000
d. $545,000

1M89
Items 9 and 10 are based on the following:

Brock Corp.'s transactions for the year ended December 31, 1988 included the following:

- Acquired 50% of Hoag Corp.'s common stock for $225,000 cash which was borrowed from a bank.
- Issued 5,000 shares of its preferred stock for land having a fair value of $400,000.
- Issued 500 of its 11% debenture bonds, due 1996, for $490,000 cash.
- Purchased a patent for $275,000 cash.
- Paid $150,000 toward a bank loan.
- Sold investment securities for $995,000.
- Had a net increase in customer deposits of $110,000.

9. Brock's net cash provided by investing activities for 1988 was

a. $370,000
b. $495,000
c. $595,000
d. $770,000

10. Brock's net cash provided by financing activities for 1988 was

a. $565,000
b. $675,000
c. $715,000
d. $825,000

1M89
Items 16 and 17 are based on the following:

Kollar Corp.'s transactions for the year ended December 31, 1988 included the following:

- Purchased real estate for $550,000 cash which was borrowed from a bank.
- Sold investment securities for $500,000.
- Paid dividends of $600,000.
- Issued 500 shares of common stock for $250,000.
- Purchased machinery and equipment for $125,000 cash.
- Paid $450,000 toward a bank loan.
- Reduced accounts receivable by $100,000.
- Increased accounts payable by $200,000.

16. Kollar's net cash used in investing activities for 1988 was
    a. $675,000
    b. $375,000
    c. $175,000
    d. $ 50,000

17. Kollar's net cash used in financing activities for 1988 was
    a. $ 50,000
    b. $250,000
    c. $450,000
    d. $500,000

D. Statement of Owners' Equity

1M92#1. United, Inc.'s unadjusted current assets section and stockholders' equity section of its December 31, 1991, balance sheet are as follows:

Current Assets:	
Cash	$ 60,000
Investments in marketable equity securities (including $300,000 of United, Inc. common stock)	400,000
Trade accounts receivable	340,000
Inventories	148,000
Total	$948,000

Stockholders' Equity:	
Common stock	$2,224,000
Retained earnings (deficit)	(224,000)
Total	$2,000,000

The investments and inventories are reported at their costs, which approximate market values.

In its 1991 statement of stockholders' equity, United's total amount of equity at December 31, 1991, is
    a. $2,224,000
    b. $2,000,000
    c. $1,924,000
    d. $1,700,000

1M92
Items 2 and 3 are based on the following:

The following format was used by Gee, Inc. for its 1991 statement of owners' equity:

	Common stock, $1 par	*Additional paid-in capital*	*Retained earnings*
Balance at 1/1/91	$90,000	$800,000	$175,000
Additions and deductions:			
100% stock dividend			
5% stock dividend			
Balance at 12/31/91			

When both the 100% and the 5% stock dividends were declared, Gee's common stock was selling for more than its $1 par value.

2. How would the 100% stock dividend affect the additional paid-in capital and retained earnings amounts reported in Gee's 1991 statement of owners' equity?

	Additional paid-in capital	*Retained earnings*
a.	Increase	Increase
b.	Increase	Decrease
c.	No change	Increase
d.	No change	Decrease

3. How would the 5% stock dividend affect the additional paid-in capital and retained earnings amounts reported in Gee's 1991 statement of owners' equity?

	Additional paid-in capital	*Retained earnings*
a.	Increase	Decrease
b.	Increase	Increase
c.	No change	Decrease
d.	No change	Increase

1M92#5. Zinc Co.'s adjusted trial balance at December 31, 1991, includes the following account balances:

Common stock, $3 par	$600,000
Additional paid-in capital	800,000
Treasury stock, at cost	50,000
Net unrealized loss on noncurrent marketable equity securities	20,000
Retained earnings: appropriated for uninsured earthquake losses	150,000
Retained earnings: unappropriated	200,000

What amount should Zinc report as total stockholders' equity in its December 31, 1991, balance sheet?
    a. $1,680,000
    b. $1,720,000
    c. $1,780,000
    d. $1,820,000

1M91#18. Data regarding Ball Corp.'s long-term marketable equity securities follow:

	Cost	*Market value*
December 31, 1989	$150,000	$130,000
December 31, 1990	150,000	160,000

Differences between cost and market values are considered temporary. The decline in market value was considered temporary and was properly accounted for at December 31, 1989. Ball's 1990 statement of changes in stockholders' equity would report an increase of

a. $30,000
b. $20,000
c. $10,000
d. $0

1M91
Items 19 and 20 are based on the following:

Pugh Co. reported the following in its statement of stockholders' equity on January 1, 1990:

Common stock, $5 par value, authorized 200,000 shares, issued 100,000 shares	$ 500,000
Additional paid-in capital	1,500,000
Retained earnings	516,000
	2,516,000
Less treasury stock, at cost, 5,000 shares	40,000
Total stockholders' equity	$2,476,000

The following events occurred in 1990:

May 1 — 1,000 shares of treasury stock were sold for $10,000.
July 9 — 10,000 shares of previously unissued common stock were sold for $12 per share.
October 1 — The distribution of a 2-for-1 stock split resulted in the common stock's per share par value being halved.

Pugh accounts for treasury stock under the cost method. Laws in the state of Pugh's incorporation protect shares held in treasury from dilution when stock dividends or stock splits are declared.

19. In Pugh's December 31, 1990, statement of stockholders' equity, the par value of the issued common stock should be

a. $550,000
b. $518,000
c. $291,000
d. $275,000

20. The number of outstanding common shares at December 31, 1990, should be

a. 222,000
b. 220,000
c. 216,000
d. 212,000

1N89#3. Jay Company acquired a wholly-owned foreign subsidiary on January 1, 1988. The stockholders' equity section of the December 31, 1988 consolidated balance sheet follows:

Common stock	$ 500,000
Additional paid-in capital	200,000
Retained earnings	900,000
	1,600,000
Less: Contra account	600,000
Total stockholders' equity	$1,000,000

The contra account balance appropriately represents adjustments in translating the foreign subsidiary's financial statements into U.S. dollars.

The consolidated income statement for 1988 included the excess of cost of investments in marketable equity securities over their market values, which is considered temporary, as follows:

Noncurrent investments	$200,000
Current investments	$100,000

The correct amounts for retained earnings and the contra accounts in the consolidated statement of stockholders' equity for the year ended December 31, 1988 are

	Retained earnings	*Contra accounts*
a.	$ 900,000	$600,000
b.	$1,000,000	$700,000
c.	$1,100,000	$800,000
d.	$1,200,000	$900,000

1M89#13. Effective April 27, 1988, the stockholders of Dorr Corp. approved a 2-for-1 split of the company's common stock, and an increase in authorized common shares from 100,000 shares (par value $20 per share) to 200,000 shares (par value $10 per share). Dorr's stockholders' equity accounts immediately before issuance of the stock split shares were as follows:

Common stock, par value $20; 100,000 shares authorized; 50,000 shares outstanding	$1,000,000
Additional paid-in capital ($3 per share on issuance of common stock)	150,000
Retained earnings	1,350,000

The stock split shares were issued on June 30, 1988. In Dorr's June 30, 1988 statement of stockholders' equity, the balances of additional paid-in capital and retained earnings are

	Additional paid-in capital	*Retained earnings*
a.	$0	$ 500,000
b.	$ 150,000	$ 350,000
c.	$ 150,000	$1,350,000
d.	$1,150,000	$ 350,000

1M89#14. On February 1, 1988, Kew Corp., a newly formed company, had the following stock issued and outstanding:

- Common stock, no par, $1 stated value, 10,000 shares originally issued for $15 per share.
- Preferred stock, $10 par value, 3,000 shares originally issued for $25 per share.

Kew's February 1, 1988 statement of stockholders' equity should report

	Common stock	*Preferred stock*	*Additional paid-in capital*
a.	$150,000	$30,000	$ 45,000
b.	$150,000	$75,000	$0
c.	$ 10,000	$75,000	$140,000
d.	$ 10,000	$30,000	$185,000

1M89#18. Munn Corp.'s records included the following stockholders' equity accounts:

Preferred stock, par value $15, authorized 20,000 shares	$255,000
Additional paid-in capital, preferred stock	15,000
Common stock, no par, $5 stated value, 100,000 shares authorized	300,000

In Munn's statement of stockholders' equity, the number of issued and outstanding shares for each class of stock is

	Common stock	*Preferred stock*
a.	60,000	17,000
b.	60,000	18,000
c.	63,000	17,000
d.	63,000	18,000

E. Consolidated Financial Statements or Worksheets

1M92#4. Wagner, a holder of a $1,000,000 Palmer, Inc. bond, collected the interest due on March 31, 1992, and then sold the bond to Seal, Inc. for $975,000. On that date, Palmer, a 75% owner of Seal, had a $1,075,000 carrying amount for this bond. What was the effect of Seal's purchase of Palmer's bond on the retained earnings and minority interest amounts reported in Palmer's March 31, 1992, consolidated balance sheet?

	Retained earnings	*Minority interest*
a.	$100,000 increase	$0
b.	$ 75,000 increase	$ 25,000 increase
c.	$0	$ 25,000 increase
d.	$0	$100,000 increase

1M92
Items 6 and 7 are based on the following:

On January 1, 1991, Dallas, Inc. purchased 80% of Style, Inc.'s outstanding common stock for $120,000. On that date, the carrying amounts of Style's assets and liabilities approximated their fair values. During 1991, Style paid $5,000 cash dividends to its stockholders. Summarized balance sheet information for the two companies follows:

	Dallas	*Style*	
	12/31/91	*12/31/91*	*1/1/91*
Investment in Style (equity method)	$132,000		
Other assets	138,000	$115,000	$100,000
	$270,000	$115,000	$100,000
Common stock	$ 50,000	$ 20,000	$ 20,000
Additional paid-in capital	80,250	44,000	44,000
Retained earnings	139,750	51,000	36,000
	$270,000	$115,000	$100,000

6. What amount should Dallas report as earnings from subsidiary, before amortization of goodwill, in its 1991 income statement?
   a. $12,000
   b. $15,000
   c. $16,000
   d. $20,000

7. What amount of total stockholders' equity should be reported in Dallas' December 31, 1991, consolidated balance sheet?
   a. $270,000
   b. $286,000
   c. $362,000
   d. $385,000

1M92
Items 8 and 9 are based on the following:

Scroll, Inc., a wholly owned subsidiary of Pirn, Inc., began operations on January 1, 1991. The following information is from the condensed 1991 income statements of Pirn and Scroll:

	Pirn	*Scroll*
Sales to Scroll	$100,000	$ —
Sales to others	400,000	300,000
	500,000	300,000
Cost of goods sold:		
Acquired from Pirn	—	80,000
Acquired from others	350,000	190,000
Gross profit	150,000	30,000
Depreciation	40,000	10,000
Other expenses	60,000	15,000
Income from operations	50,000	5,000
Gain on sale of equipment to Scroll	12,000	—
Income before income taxes	$ 38,000	$ 5,000

Additional information:

- Sales by Pirn to Scroll are made on the same terms as those made to third parties.
- Equipment purchased by Scroll from Pirn for $36,000 on January 1, 1991, is depreciated using the straight-line method over four years.

8. In Pirn's December 31, 1991, consolidating worksheet, how much intercompany profit should be eliminated from Scroll's inventory?
   a. $30,000
   b. $20,000
   c. $10,000
   d. $ 6,000

9. What amount should be reported as depreciation expense in Pirn's 1991 consolidated income statement?
   a. $50,000
   b. $47,000
   c. $44,000
   d. $41,000

1M92#11. Parker Corp. owns 80% of Smith, Inc.'s common stock. During 1991, Parker sold Smith $250,000 of inventory on the same terms as sales made to third parties. Smith sold all of the inventory purchased from Parker in 1991. The following information pertains to Smith's and Parker's sales for 1991:

	Parker	*Smith*
Sales	$1,000,000	$700,000
Cost of sales	400,000	350,000
	$ 600,000	$350,000

What amount should Parker report as cost of sales in its 1991 consolidated income statement?
   a. $750,000
   b. $680,000
   c. $500,000
   d. $430,000

1M91#7. On January 1, 1990, Poe Corp. sold a machine for $900,000 to Saxe Corp., its wholly-owned subsidiary. Poe paid $1,100,000 for this machine, which had accumulated depreciation of $250,000. Poe estimated a $100,000 salvage value and depreciated the machine on the straight-line method over 20 years, a policy which Saxe continued. In Poe's December 31, 1990, consolidated balance sheet, this machine should be included in cost and accumulated depreciation as

	Cost	*Accumulated depreciation*
a.	$1,100,000	$300,000
b.	$1,100,000	$290,000
c.	$ 900,000	$ 40,000
d.	$ 850,000	$ 42,500

1M91
Items 13 through 17 are based on the following:

The separate condensed balance sheets and income statements of Purl Corp. and its wholly-owned subsidiary, Scott Corp., are as follows:

BALANCE SHEETS
December 31, 1990

	Purl	*Scott*
Assets		
Current assets		
Cash	$ 80,000	$ 60,000
Accounts receivable (net)	140,000	25,000
Inventories	90,000	50,000
Total current assets	310,000	135,000
Property, plant, and equipment (net)	625,000	280,000
Investment in Scott (equity method)	390,000	—
Total assets	$1,325,000	$415,000
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	$ 160,000	$ 95,000
Accrued liabilities	110,000	30,000
Total current liabilities	270,000	125,000
Stockholders' equity		
Common stock ($10 par)	300,000	50,000
Additional paid-in capital	—	10,000
Retained earnings	755,000	230,000
Total stockholders' equity	1,055,000	290,000
Total liabilities and stockholders' equity	$1,325,000	$415,000

INCOME STATEMENTS
For the Year Ended December 31, 1990

	Purl	*Scott*
Sales	$2,000,000	$750,000
Cost of goods sold	1,540,000	500,000
Gross margin	460,000	250,000
Operating expenses	260,000	150,000
Operating income	200,000	100,000
Equity in earnings of Scott	60,000	—
Income before income taxes	260,000	100,000
Provision for income taxes	60,000	30,000
Net income	$ 200,000	$ 70,000

Additional information:

- On January 1, 1990, Purl purchased for $360,000 all of Scott's $10 par, voting common stock. On January 1, 1990, the fair value of Scott's assets and liabilities equaled their carrying amount of $410,000 and $160,000, respectively, except that the fair values of certain items identifiable in Scott's inventory were $10,000 more than their carrying amounts. These items were still on hand at December 31, 1990. Purl's policy is to amortize intangible assets over a 10-year period, unless a definite life is ascertainable.
- During 1990, Purl and Scott paid cash dividends of $100,000 and $30,000, respectively. For tax purposes, Purl receives the 100% exclusion for dividends received from Scott.
- There were no intercompany transactions, except for Purl's receipt of dividends from Scott and Purl's recording of its share of Scott's earnings.
- Both Purl and Scott paid income taxes at the rate of 30%.

In the December 31, 1990, consolidated financial statements of Purl and its subsidiary:

13. Total current assets should be
    a. $455,000
    b. $445,000
    c. $310,000
    d. $135,000

14. Total assets should be
    a. $1,740,000
    b. $1,450,000
    c. $1,350,000
    d. $1,325,000

15. Total retained earnings should be
    a. $985,000
    b. $825,000
    c. $795,000
    d. $755,000

16. Net income should be
    a. $270,000
    b. $200,000
    c. $190,000
    d. $170,000

17. Goodwill amortization expense should be
    a. $20,000
    b. $10,000
    c. $ 6,000
    d. $0

1N89
Items 5 through 8 are based on the following:

The separate condensed balance sheets and income statements of Dean Corp. and its wholly-owned subsidiary, Kay Corp., are as follows:

BALANCE SHEETS
December 31, 1988

	Dean	*Kay*
Assets		
Current assets	$ 430,000	$300,000
Property, plant, and equipment (net)	360,000	400,000
Investment in subsidiary (equity method)	650,000	—
Total assets	$1,440,000	$700,000
Liabilities and Stockholders' Equity		
Current liabilities	$ 130,000	$140,000
Stockholders' equity		
Common stock ($10 par)	320,000	80,000
Additional paid-in capital	370,000	200,000
Retained earnings	620,000	280,000
Total stockholders' equity	1,310,000	560,000
Total liabilities and stockholders' equity	$1,440,000	$700,000

INCOME STATEMENTS
For the Year Ended December 31, 1988

	Dean	*Kay*
Sales	$1,100,000	$600,000
Cost of goods sold	770,000	400,000
Gross profit	330,000	200,000

	Dean	Kay
Other operating expenses	120,000	100,000
Operating income	210,000	100,000
Equity in earnings of Kay	60,000	—
Income before federal income taxes	270,000	100,000
Provision for federal income taxes	70,000	30,000
Net income	$ 200,000	$ 70,000

Additional information:

- On January 1, 1988, Dean purchased all of Kay's $10 par, voting common stock for $600,000. On that date, the fair value of Kay's assets and liabilities equaled their carrying amount of $660,000 and $160,000, respectively. Dean's policy is to amortize intangibles over a 10-year period, unless a definite life is ascertainable.
- During 1988, Dean and Kay paid cash dividends of $50,000 and $10,000, respectively. For tax purposes, Dean receives the 100% exclusion for dividends received from Kay.
- There were no intercompany transactions except for Dean's receipt of dividends from Kay, and Dean's recording of its share of Kay's earnings.
- On June 30, 1988, Dean sold 2,000 shares of its common stock for $17 per share. There were no other changes in either Dean's or Kay's common stock during 1988.

5. In Dean's 1988 consolidated income statement, what amount should be reported as consolidated net income?
   a. $140,000
   b. $200,000
   c. $210,000
   d. $270,000

6. In Dean's December 31, 1988 consolidated balance sheet, what amount should be reported as total consolidated assets?
   a. $2,140,000
   b. $1,580,000
   c. $1,490,000
   d. $1,440,000

7. In Dean's December 31, 1988 consolidated balance sheet, what amount should be reported as total retained earnings?
   a. $620,000
   b. $680,000
   c. $690,000
   d. $900,000

8. In Dean's 1988 consolidated income statement, what amount should be reported for amortization of goodwill?
   a. $0
   b. $ 6,000
   c. $ 9,000
   d. $10,000

1N89

Items 10 and 11 are based on the following:

On December 31, 1988, Saxe Corporation was merged into Poe Corporation. In the business combination, Poe issued 200,000 shares of its $10 par common stock, with a market price of $18 a share, for all of Saxe's common stock. The stockholders' equity section of each company's balance sheet immediately before the combination was:

	Poe	Saxe
Common stock	$3,000,000	$1,500,000
Additional paid-in capital	1,300,000	150,000
Retained earnings	2,500,000	850,000
	$6,800,000	$2,500,000

10. Assume that the merger qualifies for treatment as a purchase. In the December 31, 1988 consolidated balance sheet, additional paid-in capital should be reported at
    a. $ 950,000
    b. $1,300,000
    c. $1,450,000
    d. $2,900,000

11. Assume that the merger qualifies for treatment as a pooling of interests. In the December 31, 1988 consolidated balance sheet, additional paid-in capital should be reported at
    a. $ 950,000
    b. $1,300,000
    c. $1,450,000
    d. $2,900,000

1M89

Items 55 and 56 are based on the following:

On January 1, 1988, Ritt Corp. purchased 80% of Shaw Corp.'s $10 par common stock for $975,000. On this date, the carrying amount of Shaw's net assets was $1,000,000. The fair values of Shaw's identifiable assets and liabilities were the same as their carrying amounts except for plant assets (net) which were $100,000 in excess of the carrying amount. For the year ended December 31, 1988, Shaw had net income of $190,000 and paid cash dividends totaling $125,000.

55. In the January 1, 1988 consolidated balance sheet, goodwill should be reported at
    a. $0
    b. $ 75,000
    c. $ 95,000
    d. $175,000

56. In the December 31, 1988 consolidated balance sheet, minority interest should be reported at
   a. $200,000
   b. $213,000
   c. $220,000
   d. $233,000

1M89
Items 57 and 58 are based on the following:

On June 30, 1988, Purl Corp. issued 150,000 shares of its $20 par common stock for which it received all of Scott Corp.'s common stock. The fair value of the common stock issued is equal to the book value of Scott Corp.'s net assets. Both corporations continued to operate as separate businesses, maintaining accounting records with years ending December 31. Net income from separate company operations and dividends paid were:

	Purl	*Scott*
Net income		
Six months ended 6/30/88	$750,000	$225,000
Six months ended 12/31/88	825,000	375,000
Dividends paid		
March 25, 1988	950,000	—
November 15, 1988	—	300,000

On December 31, 1988, Scott held in its inventory merchandise acquired from Purl on December 1, 1988 for $150,000, which included a $45,000 markup.

57. Assume that the business combination qualifies for treatment as a purchase. In the 1988 consolidated income statement, net income should be reported at
   a. $1,650,000
   b. $1,905,000
   c. $1,950,000
   d. $2,130,000

58. Assume that the business combination qualifies for treatment as a pooling of interests. In the 1988 consolidated income statement, net income should be reported at
   a. $1,905,000
   b. $1,950,000
   c. $2,130,000
   d. $2,175,000

1N88
Items 2 through 6 are based on the following:

On January 1, 1988, Polk Corp. and Strass Corp. had condensed balance sheets as follows:

	Polk	*Strass*
Current assets	$ 70,000	$20,000
Noncurrent assets	90,000	40,000
Total assets	$160,000	$60,000
Current liabilities	$ 30,000	$10,000
Long-term debt	50,000	—
Stockholders' equity	80,000	50,000
Total liabilities and stockholders' equity	$160,000	$60,000

On January 2, 1988, Polk borrowed $60,000 and used the proceeds to purchase 90% of the outstanding common shares of Strass. This debt is payable in 10 equal annual principal payments, plus interest, beginning December 30, 1988. The excess cost of the investment over Strass' book value of acquired net assets should be allocated 60% to inventory and 40% to goodwill.

On Polk's January 2, 1988 consolidated balance sheet,

2. Current assets should be
   a. $99,000
   b. $96,000
   c. $90,000
   d. $79,000

3. Noncurrent assets should be
   a. $130,000
   b. $134,000
   c. $136,000
   d. $140,000

4. Current liabilities should be
   a. $50,000
   b. $46,000
   c. $40,000
   d. $30,000

5. Noncurrent liabilities including minority interests should be
   a. $115,000
   b. $109,000
   c. $104,000
   d. $ 55,000

6. Stockholders' equity should be
   a. $ 80,000
   b. $ 85,000
   c. $ 90,000
   d. $130,000

1M88#10. King Corp. owns 80% of Lee Corp.'s common stock. During October 1987, Lee sold merchandise to King for $100,000. At December 31, 1987, one-half of the merchandise remained in King's inventory. For 1987, gross profit percentages were 30% for King and 40% for Lee. The amount of unrealized intercompany profit in ending inventory at December 31, 1987 that should be eliminated in consolidation is
   a. $40,000
   b. $20,000
   c. $16,000
   d. $15,000

1M88#11. Dunn Corp. owns 100% of Grey Corp.'s common stock. On January 2, 1986, Dunn sold to Grey for $40,000 machinery with a carrying amount of $30,000. Grey is depreciating the acquired machinery over a five-year life by the straight-line method. The net adjustments to compute 1986 and 1987 consolidated income before income tax would be an increase (decrease) of

	1986	*1987*
a.	($ 8,000)	$2,000
b.	($ 8,000)	$0
c.	($10,000)	$2,000
d.	($10,000)	$0

1M88

Items 13 through 17 are based on the following information:

On June 30, 1987, Post, Inc. issued 630,000 shares of its $5 par common stock, for which it received 180,000 shares (90%) of Shaw Corp.'s $10 par common stock, in a business combination appropriately accounted for as a pooling of interests. The stockholders' equities immediately before the combination were:

	Post	*Shaw*
Common stock	$ 6,500,000	$2,000,000
Additional paid-in capital	4,400,000	1,600,000
Retained earnings	6,100,000	5,400,000
	$17,000,000	$9,000,000

Both corporations continued to operate as separate businesses, maintaining accounting records with years ending December 31. For 1987, net income and dividends paid from separate company operations were:

	Post	*Shaw*
Net income		
Six months ended 6/30/87	$1,000,000	$300,000
Six months ended 12/31/87	1,100,000	500,000
Dividends paid		
April 1, 1987	1,300,000	—
October 1, 1987	—	350,000

13. In the June 30, 1987 consolidated balance sheet, common stock should be reported at
   a. $9,650,000
   b. $9,450,000
   c. $8,500,000
   d. $8,300,000

14. In the June 30, 1987 consolidated balance sheet, additional paid-in capital should be reported at
   a. $4,400,000
   b. $4,490,000
   c. $5,840,000
   d. $6,000,000

15. In the June 30, 1987 consolidated balance sheet, retained earnings should be reported at
   a. $ 6,100,000
   b. $ 9,660,000
   c. $10,960,000
   d. $11,500,000

16. In the 1987 consolidated income statement, net income should be reported at
   a. $2,550,000
   b. $2,600,000
   c. $2,820,000
   d. $2,900,000

17. In the December 31, 1987 consolidated balance sheet, total minority interest should be reported at
   a. $950,000
   b. $945,000
   c. $915,000
   d. $900,000

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

1M92#12. On July 1, 1991, Cody Co. paid $1,198,000 for 10%, 20-year bonds with a face amount of $1,000,000. Interest is paid on December 31 and June 30. The bonds were purchased to yield 8%. Cody uses the effective interest rate method to recognize interest income from this investment. What should be reported as the carrying amount of the bonds in Cody's December 31, 1991, balance sheet?

a. $1,207,900
b. $1,198,000
c. $1,195,920
d. $1,193,050

1M92#13. Reed, Inc. began operations on January 1, 1991. The following information pertains to Reed's December 31, 1991, portfolio of marketable equity securities:

	Current	*Noncurrent*
Aggregate cost	$360,000	$550,000
Aggregate market value	320,000	450,000
Aggregate lower of cost or market value applied to each security in the portfolio	304,000	420,000

If the market declines are judged to be temporary, what amounts should Reed report as valuation allowances for its current and noncurrent marketable equity securities in its December 31, 1991, balance sheet?

	Current	*Noncurrent*
a.	$40,000	$0
b.	$0	$100,000
c.	$40,000	$100,000
d.	$56,000	$130,000

1M92#14. The following information pertains to Smoke, Inc.'s investment in marketable equity securities:

- On December 31, 1991, Smoke reclassified a security with a $70,000 cost and a $50,000 market value from current to noncurrent.
- A noncurrent marketable equity security costing $75,000, written down to $30,000 in 1990, had a $60,000 market value on December 31, 1991. Smoke believes the recovery is permanent.

What is the net effect of the above items on Smoke's valuation allowance for noncurrent marketable equity securities as of December 31, 1991?

a. No effect.
b. $10,000 decrease.
c. $20,000 increase.
d. $30,000 decrease.

1N91#3. The following information pertains to Park Co. at December 31, 1990:

Bank statement balance	$10,000
Checkbook balance	14,000
Deposit in transit	5,000
Outstanding checks	1,000

In Park's December 31, 1990, balance sheet, cash should be reported as

a. $ 9,000
b. $10,000
c. $14,000
d. $15,000

1N91#8. On December 31, 1990, Ott Co. had investments in marketable equity securities as follows:

	Cost	*Market value*	*Lower of cost or market*
Man Co.	$10,000	$ 8,000	$ 8,000
Kemo, Inc.	9,000	11,000	9,000
Fenn Corp.	11,000	9,000	9,000
	$30,000	$28,000	$26,000

Ott's December 31, 1990, balance sheet should report the marketable equity securities as

a. $26,000
b. $28,000
c. $29,000
d. $30,000

1N91#9. On March 15, 1990, Ashe Corp. adopted a plan to accumulate $1,000,000 by September 1, 1994. Ashe plans to make four equal annual deposits to a fund that will earn interest at 10% compounded annually. Ashe made the first deposit on September 1, 1990. Future value and future amount factors are as follows:

Future value of 1 at 10% for 4 periods	1.46
Future amount of ordinary annuity of 1 at 10% for 4 periods	4.64
Future amount of annuity in advance of 1 at 10% for 4 periods	5.11

Ashe should make four annual deposits (rounded) of

a. $250,000
b. $215,500
c. $195,700
d. $146,000

1N90#1. In preparing its August 31, 1990 bank reconciliation, Apex Corp. has available the following information:

Balance per bank statement, 8/31/90	$18,050
Deposit in transit, 8/31/90	3,250
Return of customer's check for insufficient funds, 8/31/90	600
Outstanding checks, 8/31/90	2,750
Bank service charges for August	100

At August 31, 1990, Apex's correct cash balance is
  a. $18,550
  b. $17,950
  c. $17,850
  d. $17,550

1N90#2. Dey Corp. began operations in 1989. An analysis of Dey's marketable equity securities portfolio acquired in 1989 shows the following totals at December 31, 1989 for current and noncurrent assets:

	Current assets	*Noncurrent assets*
Aggregate cost	$45,000	$65,000
Aggregate market value	39,000	57,000
Aggregate lower of cost or market value applied to each security in the portfolio	38,000	56,000

What valuation allowance should Dey report in its December 31, 1989 balance sheet for the unrealized loss included in its 1989 income statement?
  a. $14,000
  b. $ 9,000
  c. $ 7,000
  d. $ 6,000

1N90#3. On January 2, 1986, Beal, Inc. acquired a $70,000 whole-life insurance policy on its president. The annual premium is $2,000. The company is the owner and beneficiary. Beal charged officer's life insurance expense as follows:

1986	$2,000
1987	1,800
1988	1,500
1989	1,100
Total	$6,400

In Beal's December 31, 1989 balance sheet, the investment in cash surrender value should be
  a. $0
  b. $1,600
  c. $6,400
  d. $8,000

1N90#4. On October 1, 1988, Park Co. purchased 200 of the $1,000 face value, 10% bonds of Ott, Inc., for $220,000, including accrued interest of $5,000. The bonds, which mature on January 1, 1995, pay interest semiannually on January 1 and July 1. Park used the straight-line method of amortization and appropriately recorded the bonds as a long-term investment. On Park's December 31, 1989 balance sheet, the bonds should be reported at
  a. $215,000
  b. $214,400
  c. $214,200
  d. $212,000

1M90#1. Poe, Inc. had the following bank reconciliation at March 31, 1990:

Balance per bank statement, 3/31/90	$46,500
Add deposit in transit	10,300
	56,800
Less outstanding checks	12,600
Balance per books, 3/31/90	$44,200

Data per bank for the month of April 1990 follow:

Deposits	$58,400
Disbursements	49,700

All reconciling items at March 31, 1990 cleared the bank in April. Outstanding checks at April 30, 1990 totaled $7,000. There were no deposits in transit at April 30, 1990. What is the cash balance per books at April 30, 1990?
  a. $48,200
  b. $52,900
  c. $55,200
  d. $58,500

1M90#2. During 1989, Scott Corp. purchased marketable equity securities as long-term investments. Pertinent data follow:

Security	*Cost*	*Market value at 12/31/89*
D	$ 36,000	$ 40,000
E	80,000	60,000
F	180,000	186,000
	$296,000	$286,000

Scott appropriately carries these securities at the lower of aggregate cost or market value. The amount of unrealized loss on these securities in Scott's 1989 income statement should be
  a. $20,000
  b. $14,000
  c. $10,000
  d. $0

1M90#3. On April 1, 1989, Saxe, Inc. purchased $200,000 face value, 9% U. S. Treasury Notes for $198,500, including accrued interest of $4,500. The notes mature July 1, 1990, and pay interest semiannually on January 1 and July 1. Saxe uses the straight-line method of amortization. The notes were sold on

December 1, 1989 for $206,500, including accrued interest of $7,500. In its October 31, 1989 balance sheet, the carrying amount of this investment should be
a. $194,000
b. $196,800
c. $197,200
d. $199,000

1M90#4. On January 1, 1988, Purl Corp. purchased as a long-term investment $500,000 face value of Shaw, Inc.'s 8% bonds for $456,200. The bonds were purchased to yield 10% interest. The bonds mature on January 1, 1994 and pay interest annually on January 1. Purl uses the interest method of amortization. What amount (rounded to nearest $100) should Purl report on its December 31, 1989 balance sheet for this long-term investment?
a. $468,000
b. $466,200
c. $461,800
d. $456,200

1M90
Item 7 is based on the following:

Lee, Inc. acquired 30% of Polk Corp.'s voting stock on January 1, 1988 for $100,000. During 1988, Polk earned $40,000 and paid dividends of $25,000. Lee's 30% interest in Polk gives Lee the ability to exercise significant influence over Polk's operating and financial policies. During 1989, Polk earned $50,000 and paid dividends of $15,000 on April 1 and $15,000 on October 1. On July 1, 1989, Lee sold half of its stock in Polk for $66,000 cash.

7. The carrying amount of this investment in Lee's December 31, 1988 balance sheet should be
a. $100,000
b. $104,500
c. $112,000
d. $115,000

2N89#1. Ral Corp.'s checkbook balance on December 31, 1988 was $5,000. In addition, Ral held the following items in its safe on that date:

Check payable to Ral Corp., dated January 2, 1989, in payment of a sale made in December 1988, not included in December 31 checkbook balance	$2,000
Check payable to Ral Corp., deposited December 15 and included in December 31 checkbook balance, but returned by Bank on December 30 stamped "NSF." The check was redeposited on January 2, 1989 and cleared on January 9	500
Check drawn on Ral Corp.'s account, payable to a vendor, dated and recorded in Ral's books on December 31 but not mailed until January 10, 1989	300

The proper amount to be shown as Cash on Ral's balance sheet at December 31, 1988 is
a. $4,800
b. $5,300
c. $6,500
d. $6,800

2N89#2. Ross Corp. was organized on January 1, 1988. At December 31, 1988, Ross had the following investment portfolio of marketable equity securities:

	In current assets	*In noncurrent assets*
Aggregate cost	$300,000	$450,000
Aggregate market value	240,000	370,000
Net unrealized loss	$ 60,000	$ 80,000

All of the declines are judged to be temporary. Valuation allowances at December 31, 1988 should be established with corresponding charges against

	Income	*Stockholders' equity*
a.	$0	$140,000
b.	$ 60,000	$ 80,000
c.	$ 80,000	$ 60,000
d.	$140,000	$0

2N89#3. Lee Corp. reported the following long-term marketable equity security on its December 31, 1987 balance sheet:

Neu Corp. common stock, at cost	$100,000
Less allowance for decline in market value	20,000
Balance	$ 80,000

At December 31, 1988, the market value of Lee's investment in the Neu Corp. stock was $85,000. As a result of the 1988 increase in this stock's market value, Lee's 1988 income statement should report
a. An unrealized gain of $5,000.
b. A realized gain of $5,000.
c. An unrealized loss of $15,000.
d. No gain or loss.

2N89#4. Key Corp. issued 1,000 shares of its nonvoting preferred stock for all of Lev Corp.'s outstanding common stock. At the date of the transaction, Key's nonvoting preferred stock had a market value of $100 per share, and Lev's tangible net assets had a book value of $60,000. In addition, Key issued 100 shares of its nonvoting preferred stock to an individual as a finder's fee for arranging the transaction. As a result of this capital transaction, Key's total net assets would increase by
a. $0
b. $ 60,000
c. $100,000
d. $110,000

1N88#1. Burr Company had the following account balances at December 31, 1987:

Cash in banks	$2,250,000
Cash on hand	125,000
Cash legally restricted for additions to plant (expected to be disbursed in 1988)	1,600,000

Cash in banks includes $600,000 of compensating balances against short-term borrowing arrangements. The compensating balances are not legally restricted as to withdrawal by Burr. In the current assets section of Burr's December 31, 1987 balance sheet, total cash should be reported at

a. $1,775,000
b. $2,250,000
c. $2,375,000
d. $3,975,000

1N88#15. On January 1, 1987, Grey Company purchased as a long-term investment 400 of the $1,000 face amount, 8% bonds of Winn Corp. for $369,000 to yield 10% annually. The bonds pay interest semiannually on July 1 and January 1, and mature on January 1, 1992. Grey uses the interest method of amortization. The bonds should be reported (rounded) on Grey's December 31, 1987 balance sheet at

a. $363,980
b. $364,100
c. $373,900
d. $374,020

1M88#1. Burr Corp. began operations on January 1, 1987, and at December 31, 1987, Burr had the following investment portfolios of marketable equity securities:

	In current assets	*In noncurrent assets*
Aggregate cost	$185,000	$275,000
Aggregate market value	150,000	225,000
Net unrealized loss	$ 35,000	$ 50,000

All the declines are judged to be temporary. Valuation allowances at December 31, 1987 should be established with corresponding charges against

	Income	*Stockholders' equity*
a.	$0	$85,000
b.	$35,000	$50,000
c.	$50,000	$35,000
d.	$85,000	$0

1M88#12. In preparing its bank reconciliation at December 31, 1987, Case Company has available the following data:

Balance per bank statement, 12/31/87	$38,075
Deposit in transit, 12/31/87	5,200
Outstanding checks, 12/31/87	6,750
Amount erroneously credited by bank to Case's account, 12/28/87	400
Bank service charges for December	75

Case's adjusted cash in bank balance at December 31, 1987 is

a. $36,525
b. $36,450
c. $36,125
d. $36,050

1M88#18. On December 31, 1986, Wall Company purchased marketable equity securities as a temporary investment. Pertinent data are as follows:

Security	*Cost*	*Market value at 12/31/87*
A	$39,000	$36,000
B	50,000	55,000
C	96,000	85,000

On December 31, 1987, Wall reclassified its investment in security C from current to noncurrent because Wall intends to retain security C as a long-term investment. What total amount of loss on its securities should be included in Wall's income statement for the year ended December 31, 1987?

a. $0
b. $ 9,000
c. $11,000
d. $14,000

B. Receivables and Accruals

1M92#10. Lion, Inc. owns 60% of Gray Corp.'s common stock. On December 31, 1991, Gray owes Lion $400,000 for a cash advance. In preparing the consolidated balance sheet at that date, what amount of the advance should be eliminated?

a. $400,000
b. $240,000
c. $160,000
d. $0

1M92#15. On December 31, 1991, Jet Co. received two $10,000 notes receivable from customers in exchange for services rendered. On both notes, interest is calculated on the outstanding principal balance at the annual rate of 3% and payable at maturity. The note from Hart Corp., made under customary trade terms, is due in nine months and the note from Maxx, Inc. is due in five years. The market interest rate for similar notes on December 31, 1991, was 8%. The compound interest factors to convert future values into present values at 8% follow:

Present value of $1 due in nine months:	.944
Present value of $1 due in five years:	.680

At what amounts should these two notes receivable be reported in Jet's December 31, 1991, balance sheet?

	Hart	*Maxx*
a.	$ 9,440	$6,800
b.	$ 9,652	$7,820
c.	$10,000	$6,800
d.	$10,000	$7,820

1M92#16. On December 1, 1991, Tigg Mortgage Co. gave Pod Corp. a $200,000, 12% loan. Pod received proceeds of $194,000 after the deduction of a $6,000 nonrefundable loan origination fee. Principal and interest are due in 60 monthly installments of $4,450, beginning January 1, 1992. The repayments yield an effective interest rate of 12% at a present value of $200,000 and 13.4% at a present value of $194,000. What amount of accrued interest receivable should Tigg include in its December 31, 1991, balance sheet?

a. $4,450
b. $2,166
c. $2,000
d. $0

1M92#21. Dolce Co., which began operations on January 1, 1990, appropriately uses the installment method of accounting to record revenues. The following information is available for the years ended December 31, 1990 and 1991:

	1990	*1991*
Sales	$1,000,000	$2,000,000
Gross profit realized on sales made in:		
1990	150,000	90,000
1991	—	200,000
Gross profit percentages	30%	40%

What amount of installment accounts receivable should Dolce report in its December 31, 1991, balance sheet?

a. $1,225,000
b. $1,300,000
c. $1,700,000
d. $1,775,000

1N91#10. Mr. & Mrs. Dart own a majority of the outstanding capital stock of Wall Corp., Black Co., and West, Inc. During 1990, Wall advanced cash to Black and West in the amounts of $50,000 and $80,000, respectively. West advanced $70,000 in cash to Black. At December 31, 1990, none of the advances was repaid. In the combined December 31, 1990, balance sheet of these companies, what amount would be reported as receivables from affiliates?

a. $200,000
b. $130,000
c. $ 60,000
d. $0

1N91#11. On July 1, 1989, Gee, Inc. leased a delivery truck from Marr Corp. under a 3-year operating lease. Total rent for the term of the lease will be $36,000, payable as follows:

12 months at $ 500 = $ 6,000
12 months at $ 750 = 9,000
12 months at $1,750 = 21,000

All payments were made when due. In Marr's June 30, 1991, balance sheet, the accrued rent receivable should be reported as

a. $0
b. $ 9,000
c. $12,000
d. $21,000

1N91#17. On July 1, 1991, Lee Co. sold goods in exchange for a $200,000, 8-month, noninterest-bearing note receivable. At the time of the sale, the note's market rate of interest was 12%. What amount did Lee receive when it discounted the note at 10% on September 1, 1991?

a. $194,000
b. $193,800
c. $190,000
d. $188,000

1N90#5. On the December 31, 1989 balance sheet of Mann Co., the current receivables consisted of the following:

Trade accounts receivable	$ 93,000
Allowance for uncollectible accounts	(2,000)
Claim against shipper for goods lost in transit (November 1989)	3,000
Selling price of unsold goods sent by Mann on consignment at 130% of cost (**not** included in Mann's ending inventory)	26,000
Security deposit on lease of warehouse used for storing some inventories	30,000
Total	$150,000

At December 31, 1989, the correct total of Mann's current net receivables was

a. $ 94,000
b. $120,000
c. $124,000
d. $150,000

1N90#6. Kemp, Inc. appropriately uses the installment method of accounting to recognize income in its financial statements. Some pertinent data relating to this method of accounting include:

	1987	*1988*	*1989*
Installment sales	$300,000	$375,000	$360,000
Cost of installment sales	225,000	285,000	252,000
Gross profit	$ 75,000	$ 90,000	$108,000
Rate of gross profit on installment sales	25%	24%	30%
Balance of deferred gross profit at year end:			
1987	$52,500	$15,000	$ -0-
1988		54,000	9,000
1989			72,000
Total	$52,500	$69,000	$81,000

What amount of installment accounts receivable should be presented in Kemp's December 31, 1989 balance sheet?

a. $270,000
b. $277,500
c. $279,000
d. $300,000

2N90#1. On July 1, 1989, Kay Corp. sold equipment to Mando Co. for $100,000. Kay accepted a 10% note receivable for the entire sales price. This note is payable in two equal installments of $50,000 plus accrued interest on December 31, 1989 and December 31, 1990. On July 1, 1990, Kay discounted the note at a bank at an interest rate of 12%. Kay's proceeds from the discounted note were

a. $48,400
b. $49,350
c. $50,350
d. $51,700

2N90#3. On June 1, 1989, Yola Corp. loaned Dale $500,000 on a 12% note, payable in five annual installments of $100,000 beginning January 2, 1990. In connection with this loan, Dale was required to deposit $5,000 in a noninterest-bearing escrow account. The amount held in escrow is to be returned to Dale after all principal and interest payments have been made. Interest on the note is payable on the first day of each month beginning July 1, 1989. Dale made timely payments through November 1, 1989. On January 2, 1990, Yola received payment of the first principal installment plus all interest due. At December 31, 1989, Yola's interest receivable on the loan to Dale should be

a. $0
b. $ 5,000
c. $10,000
d. $15,000

2N90#9. Mill Co.'s allowance for uncollectible accounts was $100,000 at the end of 1989 and $90,000 at the end of 1988. For the year ended December 31, 1989, Mill reported bad debt expense of $16,000 in its income statement. What amount did Mill debit to the appropriate account in 1989 to write off actual bad debts?

a. $ 6,000
b. $10,000
c. $16,000
d. $26,000

1M90#5. Garr Co. received a $60,000, 6-month, 10% interest-bearing note from a customer. After holding the note for two months, Garr was in need of cash and discounted the note at the United Local Bank at 12%. The amount of cash Garr received from the bank was

a. $60,480
b. $60,630
c. $61,740
d. $62,520

1M90#9. The following accounts were abstracted from Roxy Co.'s unadjusted trial balance at December 31, 1989:

	Debit	*Credit*
Accounts receivable	$1,000,000	
Allowance for uncollectible accounts	8,000	
Net credit sales		$3,000,000

Roxy estimates that 3% of the gross accounts receivable will become uncollectible. After adjustment at December 31, 1989, the allowance for uncollectible accounts should have a credit balance of

a. $90,000
b. $82,000
c. $38,000
d. $30,000

1M90#10. On June 1, 1989, Pitt Corp. sold merchandise with a list price of $5,000 to Burr on account. Pitt allowed trade discounts of 30% and 20%. Credit terms were 2/15, n/40 and the sale was made FOB shipping point. Pitt prepaid $200 of delivery costs for Burr as an accommodation. On June 12, 1989, Pitt received from Burr a remittance in full payment amounting to

a. $2,744
b. $2,940
c. $2,944
d. $3,140

1M90#11. At December 31, 1989, Grey, Inc. owned 90% of Winn Corp., a consolidated subsidiary, and 20% of Carr Corp., an investee in which Grey cannot exercise significant influence. On the same date, Grey had receivables of $300,000 from Winn and $200,000 from Carr. In its December 31, 1989 consolidated balance sheet, Grey should report accounts receivable from affiliates of

a. $500,000
b. $340,000
c. $230,000
d. $200,000

1M90#12. Rand, Inc. accepted from a customer a $40,000, 90-day, 12% interest-bearing note dated August 31, 1989. On September 30, 1989, Rand discounted the note at the Apex State Bank at 15%. However, the proceeds were not received until October 1, 1989. In Rand's September 30, 1989 balance sheet, the amount receivable from the bank, based on a 360-day year, includes accrued interest revenue of

a. $170
b. $200
c. $300
d. $400

1M90#17. On April 1, 1988, Kew Co. purchased new machinery for $300,000. The machinery has an estimated useful life of five years, and depreciation is computed by the sum-of-the-years'-digits method. The accumulated depreciation on this machinery at March 31, 1990 should be

a. $192,000
b. $180,000
c. $120,000
d. $100,000

2N89#5. Lia Co.'s December 31, 1988 balance sheet reported the following current assets:

Cash	$ 35,000
Accounts receivable	60,000
Inventories	30,000
Total	$125,000

An analysis of the accounts disclosed that accounts receivable comprised the following:

Trade accounts	$48,000
Allowance for uncollectible accounts	(1,000)
Selling price of Lia's unsold goods sent to Jax Co. on consignment at 130% of cost and **not** included in Lia's ending inventory	13,000
Total	$60,000

At December 31, 1988, the correct total of Lia's current assets is

a. $112,000
b. $115,000
c. $122,000
d. $135,000

2N89#6. Par Corp. owns 60% of Sub Corp.'s outstanding capital stock. On May 1, 1988, Par advanced Sub $70,000 in cash, which was still outstanding at December 31, 1988. What portion of this advance should be eliminated in the preparation of the December 31, 1988 consolidated balance sheet?

a. $70,000
b. $42,000
c. $28,000
d. $0

2N89#7. The following information pertains to Oro Corp.:

Credit sales for the year ended December 31, 1988	$450,000
Credit balance in allowance for uncollectible accounts at January 1, 1988	10,800
Bad debts written off during 1988	18,000

According to past experience, 3% of Oro's credit sales have been uncollectible. After provision is made for bad debt expense for the year ended December 31, 1988, the allowance for uncollectible accounts balance would be

a. $ 6,300
b. $13,500
c. $24,300
d. $31,500

2N89#8. Kul Co., which began operations on January 1, 1988, appropriately uses the installment sales method of accounting. The following information is available for 1988:

Installment accounts receivable, December 31, 1988	$400,000
Deferred gross profit, December 31, 1988 (before recognition of realized gross profit for 1988)	280,000
Gross profit on sales	40%

For the year ended December 31, 1988, cash collections and realized gross profit on installment sales should be

	Cash collections	*Realized gross profit*
a.	$300,000	$120,000
b.	$300,000	$160,000
c.	$200,000	$120,000
d.	$200,000	$160,000

1M89#8. Taft Corp., which began business on January 1, 1987, appropriately uses the installment sales method of accounting. The following data are available for December 31, 1987 and 1988:

	1987	*1988*
Balance of deferred gross profit on sales account:		
1987	$300,000	$120,000
1988	—	440,000
Gross profit on sales	30%	40%

The installment accounts receivable balance at December 31, 1988 is
a. $1,000,000
b. $1,100,000
c. $1,400,000
d. $1,500,000

1M89#15. Fay, Inc., received a $30,000, six-month, 12% interest-bearing note from a customer. The note was discounted the same day by Carr National Bank at 15%. The amount of cash received by Fay from the bank was
a. $30,000
b. $29,550
c. $29,415
d. $27,750

1N88#10. Roxy Company had the following information relating to its accounts receivable:

Accounts receivable at 12/31/86	$1,300,000
Credit sales for 1987	5,400,000
Collections from customers for 1987	4,750,000
Accounts written off 9/30/87	125,000
Collection of accounts written off in prior years (customer credit was not reestablished)	25,000
Estimated uncollectible receivables per aging of receivables at 12/31/87	165,000

At December 31, 1987, Roxy's accounts receivable, before allowance for uncollectible accounts, should be
a. $1,825,000
b. $1,850,000
c. $1,950,000
d. $1,990,000

1N88#16. Apex Company accepted from a customer a $100,000 face amount, 6-month, 8% note dated April 15, 1988. The same date Apex discounted the note at Union Bank at a 10% discount rate. How much cash should Apex receive from the bank on April 15, 1988?
a. $104,000
b. $ 99,000
c. $ 98,800
d. $ 97,200

1N88#18. On July 1, 1987, East Co. purchased as a long-term investment $500,000 face amount, 8% bonds of Rand Corp. for $461,500 to yield 10% per year. The bonds pay interest semiannually on January 1 and July 1. In its December 31, 1987 balance sheet, East should report interest receivable of
a. $18,460
b. $20,000
c. $23,075
d. $25,000

1M88#20. The following accounts were abstracted from Mann Company's unadjusted trial balance at December 31, 1987:

	Debit	*Credit*
Accounts receivable	$1,000,000	
Allowance for doubtful accounts	8,000	
Net credit sales		$4,000,000

Mann estimates that 3% of the gross accounts receivable will become uncollectible. After adjustment at December 31, 1987, the allowance for doubtful accounts should have a credit balance of
a. $ 22,000
b. $ 30,000
c. $ 38,000
d. $120,000

C. Inventories

1M92#17. Stone Co. had the following consignment transactions during December 1991:

Inventory shipped on consignment to Beta Co.	$18,000
Freight paid by Stone	900
Inventory received on consignment from Alpha Co.	12,000
Freight paid by Alpha	500

No sales of consigned goods were made through December 31, 1991. Stone's December 31, 1991, balance sheet should include consigned inventory at
a. $12,000
b. $12,500
c. $18,000
d. $18,900

1M92#18. Anders Co. uses the moving-average method to determine the cost of its inventory. During January 1992, Anders recorded the following information pertaining to its inventory:

	Units	*Unit cost*	*Total cost*
Balance on 1/1/92	40,000	$5	$200,000
Sold on 1/17/92	35,000		
Purchased on 1/28/92	20,000	8	160,000

What amount of inventory should Anders report in its January 31, 1992, balance sheet?
a. $200,000
b. $185,000
c. $162,500
d. $150,000

1N91#12. On December 28, 1990, Kerr Manufacturing Co. purchased goods costing $50,000. The terms were F.O.B. destination. Some of the costs incurred in connection with the sale and delivery of the goods were as follows:

Packaging for shipment	$1,000
Shipping	1,500
Special handling charges	2,000

These goods were received on December 31, 1990. In Kerr's December 31, 1990, balance sheet, what amount of cost for these goods should be included in inventory?

a. $54,500
b. $53,500
c. $52,000
d. $50,000

1N91#13. In 1989, Cobb adopted the dollar-value LIFO inventory method. At that time, Cobb's ending inventory had a base-year cost and an end-of-year cost of $300,000. In 1990, the ending inventory had a $400,000 base-year cost and a $440,000 end-of-year cost. What dollar-value LIFO inventory cost would be reported in Cobb's December 31, 1990, balance sheet?

a. $440,000
b. $430,000
c. $410,000
d. $400,000

1M91
Item 21 is based on the following:

During 1990, Pitt Corp. incurred costs to develop and produce a routine, low-risk computer software product, as follows:

Completion of detail program design	$13,000
Costs incurred for coding and testing to establish technological feasibility	10,000
Other coding costs after establishment of technological feasibility	24,000
Other testing costs after establishment of technological feasibility	20,000
Costs of producing product masters for training materials	15,000
Duplication of computer software and training materials from product masters (1,000 units)	25,000
Packaging product (500 units)	9,000

21. In Pitt's December 31, 1990, balance sheet, what amount should be reported in inventory?

a. $25,000
b. $34,000
c. $40,000
d. $49,000

1N90#7. The following information applied to Fenn, Inc. for 1989:

Merchandise purchased for resale	$400,000
Freight in	10,000
Freight out	5,000
Purchase returns	2,000

Fenn's 1989 inventoriable cost was

a. $400,000
b. $403,000
c. $408,000
d. $413,000

1N90#8. Ashe Co. recorded the following data pertaining to raw material X during January 1990:

	Units			
Date	*Received*	*Cost*	*Issued*	*On hand*
1/1/90 Inventory		$8.00		3,200
1/11/90 Issue			1,600	1,600
1/22/90 Purchase	4,800	$9.60		6,400

The moving-average unit cost of X inventory at January 31, 1990 is

a. $8.80
b. $8.96
c. $9.20
d. $9.60

1M90#13. Union Corp. uses the first-in, first-out retail method of inventory valuation. The following information is available:

	Cost	*Retail*
Beginning inventory	$12,000	$ 30,000
Purchases	60,000	110,000
Net additional markups		10,000
Net markdowns		20,000
Sales revenue		90,000

If the lower of cost or market rule is disregarded, what would be the estimated cost of the ending inventory?

a. $24,000
b. $20,800
c. $20,000
d. $19,200

1M90#14. West Retailers purchased merchandise with a list price of $20,000, subject to trade discounts of 20% and 10%, with no cash discounts allowable. West should record the cost of this merchandise as

a. $14,000
b. $14,400
c. $15,600
d. $20,000

2N89#10. The following information pertains to an inventory item:

Cost	$12.00
Estimated selling price	13.60
Estimated disposal cost	.20
Normal gross margin	2.20
Replacement cost	10.90

Under the lower-of-cost-or-market rule, this inventory item should be valued at
a. $10.70
b. $10.90
c. $11.20
d. $12.00

1M89#21. Grey Corp. purchased merchandise with a list price of $20,000, subject to trade discounts of 10% and 5%. What amount should Grey record as the cost of this merchandise?
a. $17,000
b. $17,100
c. $17,900
d. $20,000

1M89#22. At December 31, 1988, the following information was available from Huff Co.'s accounting records:

	Cost	*Retail*
Inventory, 1/1/88	$147,000	$ 203,000
Purchases	833,000	1,155,000
Additional markups	—	42,000
Available for sale	$980,000	$1,400,000

Sales for the year totaled $1,106,000. Markdowns amounted to $14,000. Under the approximate lower of average cost or market retail method, Huff's inventory at December 31, 1988 was
a. $308,000
b. $280,000
c. $215,600
d. $196,000

1N88#17. Dell Company's inventory at December 31, 1987 was $1,200,000 based on a physical count of goods priced at cost, and before any necessary year-end adjustments relating to the following:

- Included in the physical count were goods billed to a customer F.O.B. shipping point on December 30, 1987. These goods had a cost of $25,000 and were picked up by the carrier on January 7, 1988.
- Goods shipped F.O.B. shipping point on December 28, 1987, from a vendor to Dell were received on January 4, 1988. The invoice cost was $60,000.

What amount should Dell report as inventory in its December 31, 1987 balance sheet?
a. $1,175,000
b. $1,200,000
c. $1,235,000
d. $1,260,000

1M88#21. Ward Distribution Company has determined its December 31, 1987 inventory on a FIFO basis at $200,000. Information pertaining to that inventory follows:

Estimated selling price	$204,000
Estimated cost of disposal	10,000
Normal profit margin	30,000
Current replacement cost	180,000

Ward records losses that result from applying the lower of cost or market rule. At December 31, 1987, the loss that Ward should recognize is
a. $0
b. $ 6,000
c. $14,000
d. $20,000

1M88#22. On January 1, 1986, Poe Company adopted the dollar-value LIFO inventory method. Poe's entire inventory constitutes a single pool. Inventory data for 1986 and 1987 are as follows:

Date	*Inventory at current year cost*	*Inventory at base year cost*	*Relevant price index*
1/1/86	$150,000	$150,000	1.00
12/31/86	220,000	200,000	1.10
12/31/87	276,000	230,000	1.20

Poe's LIFO inventory value at December 31, 1987 is
a. $230,000
b. $236,000
c. $241,000
d. $246,000

D. Property, Plant, and Equipment Owned or Leased

1M92#19. On December 31, 1991, Vey Co. traded equipment with an original cost of $100,000 and accumulated depreciation of $40,000 for similar productive equipment with a fair value of $60,000. In addition, Vey received $30,000 cash in connection with this exchange. What should be Vey's carrying amount for the equipment received at December 31, 1991?
a. $30,000
b. $40,000
c. $60,000
d. $80,000

1M92#22. On December 1, 1991, Boyd Co. purchased a $400,000 tract of land for a factory site. Boyd razed an old building on the property and sold the materials it salvaged from the demolition. Boyd incurred additional costs and realized salvage proceeds during December 1991, as follows:

Demolition of old building	$50,000
Legal fees for purchase contract and recording ownership	10,000
Title guarantee insurance	12,000
Proceeds from sale of salvaged materials	8,000

In its December 31, 1991, balance sheet, Boyd should report a balance in the land account of
a. $464,000
b. $460,000
c. $442,000
d. $422,000

1N91#14. On July 1, 1990, Glen Corp. leased a new machine from Ryan Corp. The lease contains the following information:

Lease term	10 years
Useful life of the machine	12 years
Present value of the minimum lease payments	$120,000
Fair value of the machine	200,000
Executory costs	3,000

No bargain purchase option is provided, and the machine reverts to Ryan when the lease expires. What amount should Glen record as a capitalized leased asset at inception of the lease?
a. $0
b. $120,000
c. $123,000
d. $200,000

1N91#15. On January 1, 1990, Dix Co. replaced its old boiler. The following information was available on that date:

Carrying amount of old boiler	$ 8,000
Fair value of old boiler	2,000
Purchase and installation price of new boiler	100,000

The old boiler was sold for $2,000. What amount should Dix capitalize as the cost of the new boiler?
a. $ 92,000
b. $ 94,000
c. $ 98,000
d. $100,000

1N91#16. On January 1, 1989, Bay Co. acquired a land lease for a 21-year period with no option to renew. The lease required Bay to construct a building in lieu of rent. The building, completed on January 1, 1990, at a cost of $840,000, will be depreciated using the straight-line method. At the end of the lease, the building's estimated market value will be $420,000. What is the building's carrying amount in Bay's December 31, 1990, balance sheet?
a. $798,000
b. $800,000
c. $819,000
d. $820,000

1N91#18. On January 1, 1986, Lane, Inc. acquired equipment for $100,000 with an estimated 10-year useful life. Lane estimated a $10,000 salvage value and used the straight-line method of depreciation. During 1990, after its 1989 financial statements had been issued, Lane determined that, due to obsolescence, this equipment's remaining useful life was only four more years and its salvage value would be $4,000. In Lane's December 31, 1990, balance sheet, what was the carrying amount of this asset?
a. $51,500
b. $49,000
c. $41,500
d. $39,000

1N91#19. A state government condemned Cory Co.'s parcel of real estate. Cory will receive $750,000 for this property, which has a carrying amount of $575,000. Cory incurred the following costs as a result of the condemnation:

Appraisal fees to support a $750,000 value	$2,500
Attorney fees for the closing with the state	3,500
Attorney fees to review contract to acquire replacement property	3,000
Title insurance on replacement property	4,000

What amount of cost should Cory use to determine the gain on the condemnation?
a. $581,000
b. $582,000
c. $584,000
d. $588,000

1M91#23. On October 1, 1990, Shaw Corp. purchased a machine for $126,000 that was placed in service on November 30, 1990. Shaw incurred additional costs for this machine, as follows:

Shipping	$3,000
Installation	4,000
Testing	5,000

In Shaw's December 31, 1990, balance sheet, the machine's cost should be reported as
a. $126,000
b. $129,000
c. $133,000
d. $138,000

1M91#24. During 1990, Burr Co. had the following transactions pertaining to its new office building:

Purchase price of land	$ 60,000
Legal fees for contracts to purchase land	2,000
Architects' fees	8,000
Demolition of old building on site	5,000
Sale of scrap from old building	3,000
Construction cost of new building (fully completed)	350,000

In Burr's December 31, 1990, balance sheet, what amounts should be reported as the cost of land and cost of building?

	Land	*Building*
a.	$60,000	$360,000
b.	$62,000	$360,000
c.	$64,000	$358,000
d.	$65,000	$362,000

1M91#25. On January 1, 1988, Nobb Corp. signed a 12-year lease for warehouse space. Nobb has an option to renew the lease for an additional 8-year period on or before January 1, 1992. During January 1990, Nobb made substantial improvements to the warehouse. The cost of these improvements was $540,000, with an estimated useful life of 15 years. At December 31, 1990, Nobb intended to exercise the renewal option. Nobb has taken a full year's amortization on this leasehold. In Nobb's December 31, 1990, balance sheet, the carrying amount of this leasehold improvement should be

a. $486,000
b. $504,000
c. $510,000
d. $513,000

1M91#26. In January 1988, Winn Corp. purchased equipment at a cost of $500,000. The equipment had an estimated salvage value of $100,000, an estimated 8-year useful life, and was being depreciated by the straight-line method. Two years later, it became apparent to Winn that this equipment suffered a permanent impairment of value. In January 1990, management determined the carrying amount should be only $175,000, with a 2-year remaining useful life, and the salvage value should be reduced to $25,000. In Winn's December 31, 1990, balance sheet, the equipment should be reported at a carrying amount of

a. $350,000
b. $175,000
c. $150,000
d. $100,000

1M91#27. On December 31, 1990, a building owned by Carr, Inc. was destroyed by fire. Carr paid $12,000 for removal and clean-up costs. The building had a book value of $250,000 and a fair value of $280,000 on December 31, 1990. What amount should Carr use to determine the gain or loss on this involuntary conversion?

a. $250,000
b. $262,000
c. $280,000
d. $292,000

2N90#2. On January 2, 1988, Ral Co. leased land and building from an unrelated lessor for a ten-year term. The lease has a renewal option for an additional ten years, but Ral has not reached a decision with regard to the renewal option. In early January of 1988, Ral completed the following improvements to the property:

Description	*Estimated life*	*Cost*
Sales office	10 years	$47,000
Warehouse	25 years	75,000
Parking lot	15 years	18,000

Amortization of leasehold improvements for 1989 should be

a. $ 7,000
b. $ 8,900
c. $12,200
d. $14,000

2N90#4. During 1988, Yvo Corp. installed a production assembly line to manufacture furniture. In 1989, Yvo purchased a new machine and rearranged the assembly line to install this machine. The rearrangement did not increase the estimated useful life of the assembly line, but it did result in significantly more efficient production. The following expenditures were incurred in connection with this project:

Machine	$75,000
Labor to install machine	14,000
Parts added in rearranging the assembly line to provide future benefits	40,000
Labor and overhead to rearrange the assembly line	18,000

What amount of the above expenditures should be capitalized in 1989?

a. $147,000
b. $107,000
c. $ 89,000
d. $ 75,000

2N90#5. On July 1, 1986, Rey Corp. purchased computer equipment at a cost of $360,000. This equipment was estimated to have a six-year life with no residual value and was depreciated by the straight-line method. On January 3, 1989, Rey determined that this equipment could no longer process data efficiently, that its value had been permanently impaired, and that $70,000 could be recovered over the remaining useful life of the equipment. What carrying amount should Rey report on its December 31, 1989 balance sheet for this equipment?

a. $0
b. $ 50,000
c. $ 70,000
d. $150,000

2N90#13. Vore Corp. bought equipment on January 2, 1988 for $200,000. This equipment had an estimated useful life of five years and a salvage value of $20,000. Depreciation was computed by the 150% declining balance method. The accumulated depreciation balance at December 31, 1989 should be

a. $102,000
b. $ 98,000
c. $ 91,800
d. $ 72,000

1M90#15. On December 1, 1989, East Co. purchased a tract of land as a factory site for $300,000. The old building on the property was razed, and salvaged materials resulting from demolition were sold. Additional costs incurred and salvage proceeds realized during December 1989 were as follows:

Cost to raze old building	$25,000
Legal fees for purchase contract and to record ownership	5,000
Title guarantee insurance	6,000
Proceeds from sale of salvaged materials	4,000

In East's December 31, 1989 balance sheet, what amount should be reported as land?

a. $311,000
b. $321,000
c. $332,000
d. $336,000

1M90#16. On June 18, 1989, Dell Printing Co. incurred the following costs for one of its printing presses:

Purchase of collating and stapling attachment	$84,000
Installation of attachment	36,000
Replacement parts for overhaul of press	26,000
Labor and overhead in connection with overhaul	14,000

The overhaul resulted in a significant increase in production. Neither the attachment nor the overhaul increased the estimated useful life of the press. What amount of the above costs should be capitalized?

a. $0
b. $ 84,000
c. $120,000
d. $160,000

1M90#18. On January 2, 1989, Ames Corp. signed an eight-year lease for office space. Ames has the option to renew the lease for an additional four-year period on or before January 2, 1996. During January 1989, Ames incurred the following costs:

- $120,000 for general improvements to the leased premises with an estimated useful life of ten years.
- $50,000 for office furniture and equipment with an estimated useful life of ten years.

At December 31, 1989, Ames' intentions as to exercise of the renewal option are uncertain. A full year's amortization of leasehold improvements is taken for calendar year 1989. In Ames' December 31, 1989 balance sheet, accumulated amortization should be

a. $10,000
b. $15,000
c. $17,000
d. $21,250

1M90#19. On December 31, 1989, a building owned by Pine Corp. was totally destroyed by fire. The building had fire insurance coverage up to $500,000. Other pertinent information as of December 31, 1989 follows:

Building, carrying amount	$520,000
Building, fair market value	550,000
Removal and clean-up cost	10,000

During January 1990, before the 1989 financial statements were issued, Pine received insurance proceeds of $500,000. On what amount should Pine base the determination of its loss on involuntary conversion?

a. $520,000
b. $530,000
c. $550,000
d. $560,000

1M89#23. On January 2, 1989, Ashe Company entered into a ten-year noncancellable lease requiring year-end payments of $100,000. Ashe's incremental borrowing rate is 12%, while the lessor's implicit interest rate, known to Ashe, is 10%. Present value factors for an ordinary annuity for ten periods are 6.145 at 10%, and 5.650 at 12%. Ownership of the property remains with the lessor at expiration of the lease. There is no bargain purchase option. The leased property has an estimated economic life of 12 years. What amount should Ashe capitalize for this leased property on January 2, 1989?

a. $1,000,000
b. $ 614,500
c. $ 565,000
d. $0

1M89#25. On January 2, 1989, Parke Corp. replaced its boiler with a more efficient one. The following information was available on that date:

Purchase price of new boiler	$60,000
Carrying amount of old boiler	5,000
Fair value of old boiler	2,000
Installation cost of new boiler	8,000

The old boiler was sold for $2,000. What amount should Parke capitalize as the cost of the new boiler?

a. $68,000
b. $66,000
c. $63,000
d. $60,000

1M89#26. Frey, Inc. purchased a machine for $450,000 on January 2, 1987. The machine has an estimated useful life of four years and a salvage value of $50,000. The machine is being depreciated using the sum-of-the-years' digits method. The December 31, 1988 asset balance, net of accumulated depreciation, should be

a. $290,000
b. $270,000
c. $170,000
d. $135,000

1M89#27. On January 1, 1985, Evan Company purchased a machine for $400,000 and established an annual depreciation charge of $50,000 over an eight-year life. During 1988, after issuing its 1987 financial statements, Evan concluded that: (1) the machine suffered permanent impairment of its operational value, and (2) $100,000 is a reasonable estimate of the amount expected to be recovered through use of the machine for the period January 1, 1988 to December 31, 1992. In Evan's December 31, 1988 balance sheet, the machine should be reported at a carrying amount of

a. $200,000
b. $ 80,000
c. $ 50,000
d. $0

1M88#23. During 1987, Fox Company made the following expenditures relating to plant machinery and equipment:

- Renovation of a group of machines at a cost of $50,000 to secure greater efficiency in production over their remaining five-year useful lives. The project was completed on December 31, 1987.
- Continuing, frequent, and low cost repairs at a cost of $35,000.
- A broken gear on a machine was replaced at a cost of $5,000.

What total amount should be charged to repairs and maintenance in 1987?

a. $35,000
b. $40,000
c. $85,000
d. $90,000

1M88#24. On January 1, 1985, Parr, Inc. purchased a machine for $600,000 and established an annual depreciation charge of $100,000 over a six-year life. During 1987, after issuing its 1986 financial statements, Parr concluded that the machine's operational value was permanently impaired. It also concluded that $120,000 is a reasonable estimate of the total amount expected to be recovered through remaining use of the machine for the period January 1, 1987 through December 31, 1989. In Parr's December 31, 1987 balance sheet, the machine should be reported at a carrying amount of

a. $ 80,000
b. $120,000
c. $300,000
d. $360,000

1M88#25. On March 1, 1987, Kay Company purchased for $450,000 a tract of land as a factory site. An existing building on the property was razed and construction was begun on a new factory building in April 1987. Additional data are available as follows:

Cost of razing old building	$ 60,000
Title insurance and legal fees to purchase land	30,000
Architect's fees	95,000
New building construction cost	1,850,000

The capitalized cost of the completed factory building should be

a. $2,005,000
b. $1,975,000
c. $1,945,000
d. $1,910,000

E. Intangibles and Other Assets

1M92#20. Hy Corp. bought Patent A for $40,000 and Patent B for $60,000. Hy also paid acquisition costs of $5,000 for Patent A and $7,000 for Patent B. Both patents were challenged in legal actions. Hy paid $20,000 in legal fees for a successful defense of Patent A and $30,000 in legal fees for an unsuccessful defense of Patent B. What amount should Hy capitalize for patents?

a. $162,000
b. $112,000
c. $ 65,000
d. $ 45,000

1M92#23. On November 1, 1991, Key Co. paid $3,600 to renew its insurance policy for three years. At December 31, 1991, Key's unadjusted trial balance showed a balance of $90 for prepaid insurance and $4,410 for insurance expense. What amounts should be reported for prepaid insurance and insurance expense in Key's December 31, 1991, financial statements?

	Prepaid insurance	*Insurance expense*
a.	$3,300	$1,200
b.	$3,400	$1,200
c.	$3,400	$1,100
d.	$3,490	$1,010

1M92#24. Rom Corp. began business in 1991 and reported taxable income of $50,000 on its 1991 tax return. Rom elected early application of FASB Statement No. 96, *Accounting for Income Taxes.* Rom's enacted tax rate is 30% for 1991 and future years. The following is a schedule of Rom's December 31, 1991, temporary differences in thousands of dollars:

	12/31/91 Book basis over (under) tax basis	*Future taxable (deductible) amounts*			
		1992	*1993*	*1994*	*1995*
Equipment	10	(5)	5	5	5
Warranty liability	(20)	(10)	(10)		
Deferred compensation liability	(15)		(5)		(10)
Installment receivables	30	10		20	
Totals	5	(5)	(10)	25	(5)

What amount should Rom report as current deferred tax assets in its December 31, 1991, balance sheet?

a. $0
b. $1,500
c. $4,500
d. $6,000

1N91#4. Hull Co. bought a trademark from Roe Corp. on January 1, 1990, for $224,000. Hull retained an independent consultant who estimated the trademark's remaining useful life to be 50 years. Its unamortized cost on Roe's accounting records was $112,000. Hull decided to amortize the trademark over the maximum period allowed. In Hull's December 31, 1990, balance sheet, what amount should be reported as accumulated amortization?

a. $5,600
b. $4,480
c. $2,800
d. $2,240

1N91#20. On January 1, 1990, Neal Co. issued 100,000 shares of its $10 par value common stock in exchange for all of Frey, Inc.'s outstanding stock. This business combination was accounted for as a pooling of interests. The fair value of Neal's common stock on December 31, 1989, was $19 per share. The carrying amounts and fair values of Frey's assets and liabilities on December 31, 1989, were as follows:

	Carrying amount	*Fair value*
Cash	$ 240,000	$ 240,000
Receivables	270,000	270,000
Inventory	435,000	405,000
Property, plant, and equipment	1,305,000	1,440,000
Liabilities	(525,000)	(525,000)
Net assets	$1,725,000	$1,830,000

What is the amount of goodwill resulting from the business combination?

a. $175,000
b. $105,000
c. $ 70,000
d. $0

1M91
Item 22 is based on the following:

During 1990, Pitt Corp. incurred costs to develop and produce a routine, low-risk computer software product, as follows:

Completion of detail program design	$13,000
Costs incurred for coding and testing to establish technological feasibility	10,000
Other coding costs after establishment of technological feasibility	24,000
Other testing costs after establishment of technological feasibility	20,000
Costs of producing product masters for training materials	15,000
Duplication of computer software and training materials from product masters (1,000 units)	25,000
Packaging product (500 units)	9,000

22. In Pitt's December 31, 1990, balance sheet, what amount should be capitalized as software cost, subject to amortization?

a. $54,000
b. $57,000
c. $59,000
d. $69,000

1M91#28. On June 30, 1990, Union, Inc. purchased goodwill of $125,000 when it acquired the net assets of Apex Corp. During 1990, Union incurred additional costs of developing goodwill, by training Apex employees ($50,000) and hiring additional Apex employees ($25,000). Before amortization of goodwill, Union's December 31, 1990, balance sheet should report goodwill of

a. $200,000
b. $175,000
c. $150,000
d. $125,000

1M91#29. On July 1, 1990, Roxy Co. obtained fire insurance for a 3-year period at an annual premium of $72,000 payable on July 1 of each year. The first premium payment was made July 1, 1990. On October 1, 1990, Roxy paid $24,000 for real estate taxes to cover the period ending September 30, 1991. This prepayment was made to obtain a discount. In its December 31, 1990, balance sheet, Roxy should report prepaid expenses of

a. $60,000
b. $54,000
c. $48,000
d. $36,000

1M91#30. Under East Co.'s accounting system, all insurance premiums paid are debited to prepaid insurance. For interim financial reports, East makes monthly estimated charges to insurance expense with credits to prepaid insurance. Additional information for the year ended December 31, 1990, is as follows:

Prepaid insurance at December 31, 1989	$105,000
Charges to insurance expense during 1990 (including a year-end adjustment of $17,500)	437,500
Prepaid insurance at December 31, 1990	122,500

What was the total amount of insurance premiums paid by East during 1990?

a. $332,500
b. $420,000
c. $437,500
d. $455,000

1M91#32. Dell Co. adopted a defined benefit pension plan on January 1, 1990. Dell amortizes the prior service cost over 16 years and funds prior service cost by making equal payments to the fund trustee at the end of each of the first ten years. The service (normal) cost is fully funded at the end of each year. The following data are available for 1990:

Service (normal) cost for 1990	$220,000
Prior service cost:	
Amortized	83,400
Funded	114,400

Dell's prepaid pension cost at December 31, 1990, is

a. $114,400
b. $ 83,400
c. $ 31,000
d. $0

1N90#9. On April 1, 1990, Dart Co. paid $620,000 for all the issued and outstanding common stock of Wall Corp. in a transaction properly accounted for as a purchase. The recorded assets and liabilities of Wall Corp. on April 1, 1990 follow:

Cash	$ 60,000
Inventory	180,000
Property and equipment (net of accumulated depreciation of $220,000)	320,000
Goodwill (net of accumulated amortization of $50,000)	100,000
Liabilities	(120,000)
Net assets	$540,000

On April 1, 1990, Wall's inventory had a fair value of $150,000, and the property and equipment (net) had a fair value of $380,000. What is the amount of goodwill resulting from the business combination?

a. $150,000
b. $120,000
c. $ 50,000
d. $ 20,000

2N90#14. During 1989, Kent Co. incurred $204,000 of research and development costs in its laboratory to develop a patent that was granted on July 1, 1989. Legal fees and other costs associated with registration of the patent totaled $41,000. The estimated economic life of the patent is 10 years. What amount should Kent capitalize for the patent on July 1, 1989?

a. $245,000
b. $204,000
c. $ 41,000
d. $0

2N90#17. Rory Co.'s prepaid insurance was $50,000 at December 31, 1989 and $25,000 at December 31, 1988. Insurance expense was $20,000 for 1989 and $15,000 for 1988. What amount of cash disbursements for insurance would be reported in Rory's 1989 net cash flows from operating activities presented on a direct basis?

a. $55,000
b. $45,000
c. $30,000
d. $20,000

2N90#19. On January 1, 1989, Merl Corp. adopted a defined benefit pension plan. The plan's service cost of $75,000 was fully funded at the end of 1989. Prior service cost was funded by a contribution of $30,000 in 1989. Amortization of prior service cost was $12,000 for 1989. What is the amount of Merl's prepaid pension cost at December 31, 1989?

a. $18,000
b. $30,000
c. $42,000
d. $45,000

1M90#20. On January 1, 1986, Taft Co. purchased a patent for $714,000. The patent is being amortized over its remaining legal life of 15 years expiring on January

1, 2001. During 1989, Taft determined that the economic benefits of the patent would not last longer than ten years from the date of acquisition. What amount should be reported in the balance sheet for the patent, net of accumulated amortization, at December 31, 1989?

a. $428,400
b. $489,600
c. $504,000
d. $523,600

1M90#21. Black Co., organized on January 2, 1989, had pretax accounting income of $500,000 and taxable income of $800,000 for the year ended December 31, 1989. The only temporary difference is accrued product warranty costs which are expected to be paid as follows:

1990	$100,000
1991	50,000
1992	50,000
1993	100,000

The enacted income tax rates are 35% for 1989, 30% for 1990 through 1992, and 25% for 1993. Black elected early application of FASB Statement No. 96, *Accounting for Income Taxes,* in its financial statements for the year ended December 31, 1989. In Black's December 31, 1989 balance sheet, the deferred income tax asset should be

a. $ 60,000
b. $ 70,000
c. $ 85,000
d. $105,000

1N89#12. Tobin Corp. incurred $160,000 of research and development costs to develop a product for which a patent was granted on January 2, 1983. Legal fees and other costs associated with registration of the patent totaled $30,000. On March 31, 1988, Tobin paid $45,000 for legal fees in a successful defense of the patent. The total amount capitalized for this patent through March 31, 1988 should be

a. $ 75,000
b. $190,000
c. $205,000
d. $235,000

1N89#13. Mark Co. bought a franchise from Fred Co. on January 1, 1988 for $204,000. An independent consultant retained by Mark estimated that the remaining useful life of the franchise was 50 years. Its unamortized cost on Fred's books at January 1, 1988 was $68,000. Mark has decided to amortize the franchise over the maximum period allowed. What amount should be amortized for the year ended December 31, 1988?

a. $5,100
b. $4,080
c. $4,000
d. $1,700

1M89#28. Pine Football Company had a player contract with Duff that is recorded in its books at $500,000 on July 1, 1988. Ace Football Company had a player contract with Terry that is recorded in its books at $600,000 on July 1, 1988. On this date, Pine traded Duff to Ace for Terry and paid a cash difference of $50,000. The fair value of the Terry contract was $700,000 on the exchange date. After the exchange, the Terry contract should be recorded in Pine's books at

a. $550,000
b. $600,000
c. $650,000
d. $700,000

1M89#29. On April 1, 1988, Hart, Inc. paid $1,700,000 for all the issued and outstanding common stock of Ray Corp. On that date, the costs and fair values of Ray's recorded assets and liabilities were as follows:

	Cost	*Fair value*
Cash	$ 160,000	$ 160,000
Inventory	480,000	460,000
Property, plant and equipment (net)	980,000	1,040,000
Liabilities	(360,000)	(360,000)
Net assets	$1,260,000	$1,300,000

Hart amortizes goodwill over 40 years. In Hart's March 31, 1989 balance sheet, what is the amount of goodwill that should be reported as a result of this business combination?

a. $390,000
b. $400,000
c. $429,000
d. $440,000

1N88#11. On February 15, 1988, Saxe Corp. paid $3,000,000 for all the issued and outstanding common stock of Carr, Inc., in a business combination properly accounted for as a purchase. The carrying amounts and fair values of Carr's assets and liabilities on February 15, 1988, were as follows:

	Carrying amount	*Fair value*
Cash	$ 320,000	$ 320,000
Receivables	360,000	360,000
Inventory	580,000	540,000
Property, plant and equipment	1,740,000	1,920,000
Liabilities	(700,000)	(700,000)
Stockholders' equity	$2,300,000	$2,440,000

What is the amount of goodwill resulting from the business combination?

a. $700,000
b. $560,000
c. $140,000
d. $0

1N88#12. On January 1, 1987, Kew Corp. incurred organization costs of $24,000. For financial accounting purposes, Kew is amortizing these costs on the same basis as the maximum allowable for Federal income tax purposes. What portion of the organization costs will Kew defer to years subsequent to 1987?

a. $23,400
b. $19,200
c. $ 4,800
d. $0

1N88#23. Rice Corp. adopted a defined benefit pension plan on January 1, 1986. The plan does not provide any retroactive benefits for existing employees. The pension funding payment is made to the trustee on December 31 each year. The following information is available for 1986 and 1987:

	1986	*1987*
Service cost	$150,000	$165,000
Funding payment	170,000	185,000
Interest on projected benefit obligation	—	15,000
Actual return on plan assets	—	18,000
Experience gains or losses	—	—

Rice chose early adoption of the FASB Statement on Employers' Accounting for Pensions. In its December 31, 1987 balance sheet, Rice should report prepaid pension cost of

a. $20,000
b. $25,000
c. $40,000
d. $43,000

1M88#26. On July 1, 1987, Kemp Company leased office space for five years at $15,000 a month. On that date, Kemp paid the lessor the following amounts:

Rent security deposit	$ 35,000
First month's rent	15,000
Last month's rent	15,000
Nonrefundable reimbursement to lessor for modifications to the leased premises	90,000
	$155,000

Kemp made timely rental payments August 1 through December 1, 1987. What portion of the payments to the lessor should Kemp have recognized as deferred to years beyond 1987?

a. $140,000
b. $131,000
c. $125,000
d. $ 50,000

1M88#27. Frey Corp. incurred $175,000 of research and development costs in its laboratory to develop a patent granted on January 2, 1984. Legal fees and other costs associated with registration of the patent totaled $35,000. On April 25, 1988, Frey paid $50,000 for legal fees in a successful defense of the patent. The total amount capitalized for this patent through April 25, 1988 should be

a. $260,000
b. $210,000
c. $ 85,000
d. $ 35,000

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals

1M92#25. Webb Co. implemented a defined benefit pension plan for its employees on January 1, 1988. During 1988 and 1989, Webb's contributions fully funded the plan. The following data are provided for 1991 and 1990:

	1991 Estimated	*1990 Actual*
Projected benefit obligation, December 31	$750,000	$700,000
Accumulated benefit obligation, December 31	520,000	500,000
Plan assets at fair value, December 31	675,000	600,000
Projected benefit obligation in excess of plan assets	75,000	100,000
Pension expense	90,000	75,000
Employer's contribution	?	50,000

What amount should Webb contribute in order to report an accrued pension liability of $15,000 in its December 31, 1991, balance sheet?

a. $ 50,000
b. $ 60,000
c. $ 75,000
d. $100,000

1M92#26. On January 2, 1990, Ross Co. purchased a machine for $70,000. This machine has a 5-year useful life, a residual value of $10,000, and is depreciated using the straight-line method for financial statement purposes. For tax purposes, depreciation expense were $25,000 for 1990 and $20,000 for 1991. Ross elected early application of FASB Statement No. 96, *Accounting for Income Taxes.* Ross' 1991 income, before income taxes and depreciation expense, was $100,000 and its tax rate was 30%. If Ross had made **no** estimated tax payments during 1991, what amount of current income tax liability would Ross report in its December 31, 1991, balance sheet?

a. $26,400
b. $25,800
c. $24,000
d. $22,500

1N91#21. At December 31, 1990, Cain, Inc. owed notes payable of $1,750,000, due on May 15, 1991. Cain expects to retire this debt with proceeds from the sale of 100,000 shares of its common stock. The stock was sold for $15 per share on March 10, 1991, prior to the issuance of the year-end financial statements. In Cain's December 31, 1990, balance sheet, what amount of the notes payable should be excluded from current liabilities?

a. $0
b. $ 250,000
c. $1,500,000
d. $1,750,000

1N91#22. Wolf Co.'s grant of 30,000 stock appreciation rights enables key employees to receive cash equal to the difference between $20 and the market price of the stock on the date each right is exercised. The service period is 1989 through 1991, and the rights are exercisable in 1992 and 1993. The market price of the stock was $25 and $28 at December 31, 1989 and 1990, respectively. What amount should Wolf report as the liability under the stock appreciation rights plan in its December 31, 1990, balance sheet?

a. $0
b. $130,000
c. $160,000
d. $240,000

1N91#23. On June 1, 1988, Ward Corp. established a defined benefit pension plan for its employees. The following information was available at May 31, 1990:

Projected benefit obligation	$14,500,000
Accumulated benefit obligation	12,000,000
Unfunded accrued pension cost	200,000
Plan assets at fair market value	7,000,000
Unrecognized prior service cost	2,550,000

To report the proper pension liability in Ward's May 31, 1990, balance sheet, what is the amount of the adjustment required?

a. $2,250,000
b. $4,750,000
c. $4,800,000
d. $7,300,000

1N91#25. Dunn Co.'s 1990 income statement reported $90,000 income before provision for income taxes. To compute the provision for federal income taxes, the following 1990 data are provided:

Rent received in advance	$16,000
Income from exempt municipal bonds	20,000
Depreciation deducted for income tax purposes in excess of depreciation reported for financial statement purposes	10,000
Enacted corporate income tax rate	30%

If the alternative minimum tax provisions are ignored, what amount of current federal income tax liability should be reported in Dunn's December 31, 1990, balance sheet?

a. $18,000
b. $22,800
c. $25,800
d. $28,800

1N91#26. On the first day of each month, Bell Mortgage Co. receives from Kent Corp. an escrow deposit of $2,500 for real estate taxes. Bell records the $2,500 in an escrow account. Kent's 1990 real estate tax is $28,000, payable in equal installments on the first day of each calendar quarter. On December 31, 1989, the balance in the escrow account was $3,000. On September 30, 1990, what amount should Bell show as an escrow liability to Kent?

a. $ 1,500
b. $ 4,500
c. $ 8,500
d. $11,500

1M91#33. Mann Corp.'s liability account balances at June 30, 1989, included a 10% note payable in the amount of $3,600,000. The note is dated October 1, 1988, and is payable in three equal annual payments of $1,200,000 plus interest. The first interest and principal payment was made on October 1, 1989. In Mann's June 30, 1990, balance sheet, what amount should be reported as accrued interest payable for this note?

a. $270,000
b. $180,000
c. $ 90,000
d. $ 60,000

1M91#34. Kew Co.'s accounts payable balance at December 31, 1990, was $2,200,000 before considering the following data:

- Goods shipped to Kew F.O.B. shipping point on December 22, 1990, were lost in transit. The invoice cost of $40,000 was not recorded by Kew. On January 7, 1991, Kew filed a $40,000 claim against the common carrier.

- On December 27, 1990, a vendor authorized Kew to return, for full credit, goods shipped and billed at $70,000 on December 3, 1990. The returned goods were shipped by Kew on December 28, 1990. A $70,000 credit memo was received and recorded by Kew on January 5, 1991.

- Goods shipped to Kew F.O.B. destination on December 20, 1990, were received on January 6, 1991. The invoice cost was $50,000.

What amount should Kew report as accounts payable in its December 31, 1990, balance sheet?
a. $2,170,000
b. $2,180,000
c. $2,230,000
d. $2,280,000

1M91#35. Ames, Inc. has $500,000 of notes payable due June 15, 1991. Ames signed an agreement on December 1, 1990, to borrow up to $500,000 to refinance the notes payable on a long-term basis with no payments due until 1992. The financing agreement stipulated that borrowings may not exceed 80% of the value of the collateral Ames was providing. At the date of issuance of the December 31, 1990, financial statements, the value of the collateral was $600,000 and is not expected to fall below this amount during 1991. In Ames' December 31, 1990, balance sheet, the obligation for these notes payable should be classified as

	Short-term	*Long-term*
a.	$500,000	$0
b.	$100,000	$400,000
c.	$ 20,000	$480,000
d.	$0	$500,000

1M91#36. Pine Corp. is required to contribute, to an employee stock ownership plan (ESOP), 10% of its income after deduction for this contribution but before income tax. Pine's income before charges for the contribution and income tax was $75,000. The income tax rate is 30%. What amount should be accrued as a contribution to the ESOP?
a. $7,500
b. $6,818
c. $5,250
d. $4,773

1M91#37. Kemp Co. must determine the December 31, 1990, year-end accruals for advertising and rent expenses. A $500 advertising bill was received January 7, 1991, comprising costs of $375 for advertisements in December 1990 issues, and $125 for advertisements in January 1991 issues of the newspaper.

A store lease, effective December 16, 1989, calls for fixed rent of $1,200 per month, payable one month from the effective date and monthly thereafter. In addition, rent equal to 5% of net sales over $300,000 per calendar year is payable on January 31 of the following year. Net sales for 1990 were $550,000.

In its December 31, 1990, balance sheet, Kemp should report accrued liabilities of
a. $12,875
b. $13,000
c. $13,100
d. $13,475

1M91#38. Bart Co. requires nonrefundable advance payments with special orders for machinery constructed to customer specifications. Information for 1990 is as follows:

Customer advances — balance 12/31/89	$590,000
Advances received with orders in 1990	920,000
Advances applied to orders shipped in 1990	820,000
Advances applicable to orders cancelled in 1990	250,000

In Bart's December 31, 1990, balance sheet, what amount should be reported as a current liability for customer deposits?
a. $740,000
b. $690,000
c. $440,000
d. $0

1M91#39. Fell, Inc. operates a retail grocery store that is required by law to collect refundable deposits of $.05 on soda cans. Information for 1990 follows:

Liability for returnable deposits—12/31/89	$150,000
Cans of soda sold in 1990	10,000,000
Soda cans returned in 1990	11,000,000

On February 1, 1990, Fell subleased space and received a $25,000 deposit to be applied toward rent at the expiration of the lease in 1994. In Fell's December 31, 1990, balance sheet, the current and noncurrent liabilities for deposits were

	Current	*Noncurrent*
a.	$125,000	$0
b.	$100,000	$ 25,000
c.	$100,000	$0
d.	$ 25,000	$100,000

1N90#10. Black Corp.'s accounts payable at December 31, 1989, totaled $900,000 before any necessary year-end adjustments relating to the following transactions:

- On December 27, 1989, Black wrote and recorded checks to creditors totaling $400,000 causing an overdraft of $100,000 in Black's bank account at December 31, 1989. The checks were mailed out on January 10, 1990.

- On December 28, 1989, Black purchased and received goods for $153,061, terms 2/10, n/30. Black records purchases and accounts payable at net amounts. The invoice was recorded and paid January 3, 1990.

- Goods shipped F.O.B. destination on December 20, 1989 from a vendor to Black were received January 2, 1990. The invoice cost was $65,000.

At December 31, 1989, what amount should Black report as total accounts payable?

a. $1,515,000
b. $1,450,000
c. $1,153,061
d. $1,053,061

1N90#11. Included in Lee Corp.'s liability account balances at December 31, 1989, were the following:

14% note payable issued October 1, 1989, maturing September 30, 1990	$125,000
16% note payable issued April 1, 1987, payable in six equal annual installments of $50,000 beginning April 1, 1988	200,000

Lee's December 31, 1989 financial statements were issued on March 31, 1990. On January 15, 1990, the entire $200,000 balance of the 16% note was refinanced by issuance of a long-term obligation payable in a lump sum. In addition, on March 10, 1990, Lee consummated a noncancelable agreement with the lender to refinance the 14%, $125,000 note on a long-term basis, on readily determinable terms that have not yet been implemented. Both parties are financially capable of honoring the agreement, and there have been no violations of the agreement's provisions. On the December 31, 1989 balance sheet, the amount of the notes payable that Lee should classify as short-term obligations is

a. $175,000
b. $125,000
c. $ 50,000
d. $0

1N90#12. Bloy Corp.'s payroll for the pay period ended October 31, 1989 is summarized as follows:

			Amount of wages subject to payroll taxes	
Department payroll	*Total wages*	*Federal income tax withheld*	*F.I.C.A.*	*Unemployment*
Factory	$ 60,000	$ 7,000	$56,000	$18,000
Sales	22,000	3,000	16,000	2,000
Office	18,000	2,000	8,000	—
	$100,000	$12,000	$80,000	$20,000

Assume the following payroll tax rates:

F.I.C.A. for employer and employee	7% each
Unemployment	3%

What amount should Bloy accrue as its share of payroll taxes in its October 31, 1989 balance sheet?

a. $18,200
b. $12,600
c. $11,800
d. $ 6,200

1N90#13. On September 1, 1988, Cobb Co. issued a note payable to National Bank in the amount of $900,000, bearing interest at 12%, and payable in three equal annual principal payments of $300,000. On this date, the bank's prime rate was 11%. The first payment for interest and principal was made on September 1, 1989. At December 31, 1989, Cobb should record accrued interest payable of

a. $36,000
b. $33,000
c. $24,000
d. $22,000

1N90#14. On January 1, 1989, Glen Co. leased a building to Dix Corp. for a ten-year term at an annual rental of $50,000. At inception of the lease, Glen received $200,000 covering the first two years' rent of $100,000 and a security deposit of $100,000. This deposit will not be returned to Dix upon expiration of the lease but will be applied to payment of rent for the last two years of the lease. What portion of the $200,000 should be shown as a current and long-term liability, respectively, in Glen's December 31, 1989 balance sheet?

	Current liability	*Long-term liability*
a.	$0	$200,000
b.	$ 50,000	$100,000
c.	$100,000	$100,000
d.	$100,000	$ 50,000

1N90#15. At December 31, 1989, the following information was provided by the Kerr Corp. pension plan administrator:

Fair value of plan assets	$3,450,000
Accumulated benefit obligation	4,300,000
Projected benefit obligation	5,700,000

What is the amount of the pension liability that should be shown on Kerr's December 31, 1989 balance sheet?

a. $5,700,000
b. $2,250,000
c. $1,400,000
d. $ 850,000

1N90#16. Pine Corp.'s books showed pretax income of $800,000 for the year ended December 31, 1989. In the computation of federal income taxes, the following data were considered:

Gain on an involuntary conversion (Pine has elected to replace the property within the statutory period using total proceeds.)	$350,000
Depreciation deducted for tax purposes in excess of depreciation deducted for book purposes	50,000
Federal estimated tax payments, 1989	70,000
Enacted federal tax rates, 1989	30%

What amount should Pine report as its current federal income tax liability on its December 31, 1989 balance sheet?

a. $ 50,000
b. $ 65,000
c. $120,000
d. $135,000

1M90#22. Rice Co. salaried employees are paid biweekly. Advances made to employees are paid back by payroll deductions. Information relating to salaries follows:

	12/31/88	*12/31/89*
Employee advances	$24,000	$ 36,000
Accrued salaries payable	40,000	?
Salaries expense during the year		420,000
Salaries paid during the year (gross)		390,000

In Rice's December 31, 1989 balance sheet, accrued salaries payable was

a. $94,000
b. $82,000
c. $70,000
d. $30,000

1M90#23. At December 31, 1988, a $1,200,000 note payable was included in Cobb Corp.'s liability account balances. The note is dated October 1, 1988, bears interest at 15%, and is payable in three equal annual payments of $400,000. The first interest and principal payment was made on October 1, 1989. In its December 31, 1989 balance sheet, what amount should Cobb report as accrued interest payable for this note?

a. $135,000
b. $ 90,000
c. $ 45,000
d. $ 30,000

1M90#26. Graf Corp.'s 1989 income statement showed pretax accounting income of $200,000. To compute the federal income tax liability, the following 1989 data are provided:

Income from exempt municipal bonds	$10,000
Depreciation deducted for tax purposes in excess of depreciation deducted for financial statement purposes	$20,000
Estimated federal income tax payments made	$40,000
Enacted corporate income tax rate	30%

If the alternate minimum tax provisions are ignored, what amount of current federal income tax liability should be included in Graf's December 31, 1989 balance sheet?

a. $11,000
b. $20,000
c. $39,000
d. $51,000

1M90#27. The balance in Kemp Corp.'s accounts payable account at December 31, 1989 was $900,000 before any necessary year-end adjustment relating to the following:

- Goods were in transit to Kemp from a vendor on December 31, 1989. The invoice cost was $50,000. The goods were shipped F.O.B. shipping point on December 29, 1989 and were received on January 4, 1990.
- Goods shipped F.O.B. destination on December 21, 1989 from a vendor to Kemp were received on January 6, 1990. The invoice cost was $25,000.
- On December 27, 1989, Kemp wrote and recorded checks to creditors totaling $40,000 that were mailed on January 10, 1990.

In Kemp's December 31, 1989 balance sheet, the accounts payable should be

a. $940,000
b. $950,000
c. $975,000
d. $990,000

1M90#29. On December 30, 1989, Bart, Inc. purchased a machine from Fell Corp. in exchange for a noninterest bearing note requiring eight payments of $20,000. The first payment was made on December 30, 1989, and the others are due annually on December 30. At date of issuance, the prevailing rate of interest for this type of note was 11%. Present value factors are as follows:

Period	*Present value of ordinary annuity of 1 at 11%*	*Present value of annuity in advance of 1 at 11%*
7	4.712	5.231
8	5.146	5.712

On Bart's December 31, 1989 balance sheet, the note payable to Fell was

a. $ 94,240
b. $102,920
c. $104,620
d. $114,240

1M90#30. Marr Co. sells its products in reusable containers. The customer is charged a deposit for each container delivered and receives a refund for each container returned within two years after the year of delivery. Marr accounts for the containers not returned within the time limit as being retired by sale at the deposit amount. Information for 1989 is as follows:

Container deposits at December 31, 1988 from deliveries in:

1987	$150,000	
1988	430,000	$580,000

Deposits for containers delivered in 1989	780,000

Deposits for containers returned in 1989 from deliveries in:

1987	$ 90,000	
1988	250,000	
1989	286,000	626,000

In Marr's December 31, 1989 balance sheet, the liability for deposits on returnable containers should be

a. $494,000
b. $584,000
c. $674,000
d. $734,000

1N89#15. Cey, Inc. determined that it has an obligation relating to employees' rights to receive compensation for future absences attributable to employees' services already rendered. The obligation relates to rights that accumulate and vest. Payment of this compensation is probable. The amounts of Cey's obligations at December 31, 1988 are reasonably estimated as follows:

Vacation pay	$90,000
Sick pay	60,000

In Cey's December 31, 1988 balance sheet, what amount should be reported as a liability for compensated absences?

a. $0
b. $ 60,000
c. $ 90,000
d. $150,000

1N89#16. Fay Corp. pays its outside salespersons fixed monthly salaries and commissions on net sales. Sales commissions are computed and paid on a monthly basis (in the month following the month of sale), and the fixed salaries are treated as advances against commissions. However, if the fixed salaries for salespersons exceed their sales commissions earned for a month, such excess is not charged back to them. Pertinent data for the month of March 1988 for the three salespersons are as follows:

Salesperson	*Fixed salary*	*Net sales*	*Commission rate*
A	$10,000	$ 200,000	4%
B	14,000	400,000	6%
C	18,000	600,000	6%
Totals	$42,000	$1,200,000	

What amount should Fay accrue for sales commissions payable at March 31, 1988?

a. $70,000
b. $68,000
c. $28,000
d. $26,000

1N89#17. On December 31, 1988, Wall Corp. issued $100,000 maturity value, 10% bonds for $100,000 cash. The bonds are dated December 31, 1988 and mature on December 31, 1998. Interest will be paid semi-annually on June 30 and December 31. In Wall's September 30, 1989 balance sheet, the amount of accrued interest expense should be

a. $ 2,500
b. $ 5,000
c. $ 7,500
d. $10,000

1N89#18. Jerry Corp., a company whose stock is publicly traded, provides a noncontributory defined benefit pension plan for its employees. The company's actuary has provided the following information for the year ended December 31, 1988:

Projected benefit obligation	$400,000
Accumulated benefit obligation	350,000
Plan assets (fair value)	410,000
Service cost	120,000
Interest on projected benefit obligation	12,000
Amortization of unrecognized prior service cost	30,000
Expected and actual return on plan assets	41,000

The market-related asset value equals the fair value of plan assets. Prior contributions to the defined benefit pension plan equaled the amount of net periodic pension cost accrued for the previous year end. No contributions have been made for 1988 pension cost. In its December 31, 1988 balance sheet, Jerry should report an accrued pension cost of

a. $203,000
b. $162,000
c. $121,000
d. $109,000

1N89#19. A state requires quarterly sales tax returns to be filed with the sales tax bureau by the 20th day following the end of the calendar quarter. However, the state further requires that sales taxes collected be remitted to the sales tax bureau by the 20th day of the month following any month such collections exceed $500. These payments can be taken as credits on the quarterly sales tax return.

Taft Corp. operates a retail hardware store. All items are sold subject to a 6% state sales tax, which Taft collects and records as sales revenue. The sales taxes paid by Taft are charged against sales revenue. Taft pays the sales taxes when they are due.

Following is a monthly summary appearing in Taft's first quarter 1989 sales revenue account:

	Debit	*Credit*
January	$ —	$10,600
February	600	7,420
March	—	9,540
	$600	$27,560

In its financial statements for the quarter ended March 31, 1989, Taft's sales revenue and sales taxes payable would be

	Sales revenue	*Sales taxes payable*
a.	$27,560	$1,560
b.	$26,960	$ 600
c.	$26,000	$1,560
d.	$26,000	$ 960

1N89#20. On January 1, 1988, Mill Corp. leased a machine to Ott Corp. for a five-year term at an annual rental of $50,000. The lease is an operating lease. At the inception of the lease Mill received $100,000, covering the first year's rent of $50,000 and a security deposit of $50,000. This deposit will not be returned to Ott upon expiration of the lease, but will instead be applied to payment of rent for the last year of the lease. Mill properly reported rental revenue of $100,000 in its 1988 income tax return. Mill's tax rate was 30%. In Mill's December 31, 1988 balance sheet, what portion of the $100,000 should be reported as a liability?

a. $50,000
b. $40,000
c. $35,000
d. $28,000

1N89#21. Grey operates as a retail furrier. Some customers pick out furs and place deposits with Grey to set the furs aside for future delivery. Grey records the cash receipts on these transactions as lay-away plan sales. However, title to the fur passes to the customer only when the full sales price is received by Grey. The average gross margin on the furs is 75% of sales. The following pertinent data were taken from Grey's December 31, 1988 unadjusted trial balance:

Regular sales	$2,500,000
Lay-away plan sales	$1,000,000
Deposits from customers	$0

An analysis of the lay-away plan sales revealed that $600,000 was received in full payment for furs delivered to customers during 1988. In Grey's December 31, 1988 balance sheet, deposits from customers would be

a. $1,000,000
b. $ 750,000
c. $ 600,000
d. $ 400,000

1M89#24. The following information relating to compensated absences was available from Graf Company's accounting records at December 31, 1988:

- Employees' rights to vacation pay vest and are attributable to services already rendered. Payment is probable, and Graf's obligation was reasonably estimated at $110,000.
- Employees' rights to sick pay benefits do not vest but accumulate for possible future use. The rights are attributable to services already rendered, and the total accumulated sick pay was reasonably estimated at $50,000.

What amount is Graf required to report as the liability for compensated absences in its December 31, 1988 balance sheet?

a. $160,000
b. $110,000
c. $ 50,000
d. $0

1M89#30. Case Corp. had accounts payable of $100,000 recorded in the general ledger as of December 31, 1988 before consideration of the following unrecorded transactions:

Invoice date	*Amount*	*Date shipped*	*Date received*	*FOB terms*
1-3-89	$ 8,000	12-22-88	12-24-88	Destination
1-2-89	13,000	12-28-88	1-2-89	Shipping point
12-26-88	12,000	1-2-89	1-3-89	Shipping point
1-10-89	9,000	12-31-88	1-5-89	Destination
	$42,000			

In Case's December 31, 1988 balance sheet, the accounts payable should be reported in the amount of

a. $100,000
b. $108,000
c. $121,000
d. $142,000

1M89#32. Included in Witt Corp.'s liability account balances at December 31, 1988 were the following:

14% note payable issued October 1, 1988, maturing September 30, 1989	$500,000
16% note payable issued April 1, 1986 payable in six equal annual installments of $200,000 beginning April 1, 1987	800,000

Witt's December 31, 1988 financial statements were issued on March 31, 1989. On January 15, 1989, the entire $800,000 balance of the 16% note was refinanced by issuance of a long-term obligation payable in a lump sum. In addition, on March 10, 1989, Witt consummated a noncancelable agreement with the lender to refinance the 14%, $500,000 note on a long-term basis, on readily determinable terms that have not yet been implemented. Both parties are financially capable of honoring the agreement, and there have been no violations of the agreement's provisions. On the December 31, 1988 balance sheet, the amount of the notes payable that Witt should classify as short-term obligations is

a. $700,000
b. $500,000
c. $200,000
d. $0

1M89#35. As of December 31, 1987, the projected benefit obligation and plan assets of a noncontributory defined benefit plan sponsored by Reed, Inc. were:

Projected benefit obligation	$780,000
Plan assets at fair value	600,000
Initial unfunded obligation	$180,000

Reed elected to apply the provisions of FASB Statement No. 87, *Employers' Accounting for Pensions,* in its financial statements for the year ended December 31, 1988. At December 31, 1987, all amounts accrued as net periodic pension cost had been contributed to the plan. The average remaining service period of active plan participants expected to receive benefits was estimated to be 10 years at the date of transition. Some participants' estimated service periods are 20 and 25 years. To minimize an accrual for pension cost, what amount of unrecognized net obligation should Reed amortize?

a. $ 7,200
b. $ 9,000
c. $12,000
d. $18,000

1M89#36. Kent, Inc., a calendar year company, established a defined benefit pension plan in December 1987. The following data relate to this plan at December 31, 1988:

Projected benefit obligation	$4,700,000
Accumulated benefit obligation	4,000,000
Total fair value of plan assets	3,000,000

Kent elected to apply the provisions of FASB Statement No. 87, *Employers' Accounting for Pensions,* in its financial statements for the year ended December 31, 1988.

In its December 31, 1988 balance sheet, Kent should report a minimum liability relating to the pension plan of

a. $4,000,000
b. $1,700,000
c. $1,000,000
d. $0

1M89#38. The Ward Corp.'s books showed income of $300,000 before provision for income tax for the year ended December 31, 1988. In the computation of taxable income for federal income tax purposes, the following items should be noted:

Income from exempt municipal bonds	$30,000
Depreciation deducted for tax purposes in excess of depreciation recorded on the books	$60,000
Proceeds received for life insurance on death of officer	$50,000
Estimated tax payments	$0
Enacted corporate income tax rate	30%

Ignore the alternate minimum tax provisions. What amount should Ward record as its current federal income tax liability at December 31, 1988?

a. $81,000
b. $75,000
c. $57,000
d. $48,000

1N88#13. Dean Company's accounts payable balance at December 31, 1987 was $1,800,000 before considering the following transactions:

- Goods were in transit from a vendor to Dean on December 31, 1987. The invoice price was $100,000, and the goods were shipped F.O.B. shipping point on December 29, 1987. The goods were received on January 4, 1988.
- Goods shipped to Dean, F.O.B. shipping point on December 20, 1987, from a vendor were lost in transit. The invoice price was $50,000. On January 5, 1988, Dean filed a $50,000 claim against the common carrier.

In its December 31, 1987 balance sheet, Dean should report accounts payable of

a. $1,950,000
b. $1,900,000
c. $1,850,000
d. $1,800,000

1M88#28. The balance in Reed Company's accounts payable account at December 31, 1987 was $1,225,000 before the following information was considered:

- Goods shipped F.O.B. destination on December 21, 1987 from a vendor to Reed were lost in transit. The invoice cost of $45,000 was not recorded by Reed. On December 28, 1987, Reed notified the vendor of the lost shipment.
- Goods were in transit from a vendor to Reed on December 31, 1987. The invoice cost was $60,000, and the goods were shipped F.O.B. shipping point on December 28, 1987. Reed received the goods on January 6, 1988.

What amount should Reed report as accounts payable in its December 31, 1987 balance sheet?

a. $1,330,000
b. $1,285,000
c. $1,270,000
d. $1,225,000

1M88#29. On September 1, 1987, Howe Corp. offered special termination benefits to employees who had reached the early retirement age specified in the company's pension plan. The termination benefits consisted of lump-sum and periodic future payments. Additionally, the employees accepting the company offer receive the usual early retirement pension benefits. The offer expired on November 30, 1987. Actual or reasonably estimated amounts at December 31, 1987 relating to the employees accepting the offer are as follows:

- Lump-sum payments totaling $475,000 were made on January 1, 1988.
- Periodic payments of $60,000 annually for three years will begin January 1, 1989. The present value at December 31, 1987, of these payments was $155,000.
- Reduction of accrued pension costs at December 31, 1987 for the terminating employees was $45,000.

In its December 31, 1987 balance sheet, Howe should report a total liability for special termination benefits of

a. $475,000
b. $585,000
c. $630,000
d. $655,000

1M88#30. Glen Corp. had the following data relating to its defined benefit pension plan at December 31, 1987:

Projected benefit obligation	$4,000,000
Accumulated benefit obligation	3,500,000
Total fair value of plan assets	2,500,000

Glen chose early adoption of the FASB Statement on Employers' Accounting for Pensions for the year ended December 31, 1986. In its December 31, 1987 balance sheet, Glen should report a minimum liability relating to the pension plan of

a. $ 500,000
b. $1,000,000
c. $1,500,000
d. $3,500,000

B. Deferred Revenues

1M92
Items 27 and 28 are based on the following:

Baker Co. is a real estate developer that began operations on January 2, 1990. Baker appropriately uses the installment method of revenue recognition. Baker's sales are made on the basis of a 10% downpayment, with the balance payable over 30 years. Baker's gross profit percentage is 40%. Relevant information for Baker's first two years of operations is as follows:

	1991	*1990*
Sales	$16,000,000	$14,000,000
Cash collections	2,020,000	1,400,000

27. At December 31, 1990, Baker's deferred gross profit was

a. $ 5,040,000
b. $ 5,600,000
c. $ 8,400,000
d. $12,600,000

28. Baker's realized gross profit for 1991 was

a. $6,400,000
b. $2,020,000
c. $1,212,000
d. $ 808,000

1M92#31. The following information pertains to a sale and leaseback of equipment by Mega Co. on December 31, 1991:

Sales price	$400,000
Carrying amount	$300,000
Monthly lease payment	$3,250
Present value of lease payments	$36,900
Estimated remaining life	25 years
Lease term	1 year
Implicit rate	12%

What amount of deferred gain on the sale should Mega report at December 31, 1991?

a. $0
b. $ 36,900
c. $ 63,100
d. $100,000

1N91#27. Each of Potter Pie Co.'s 21 new franchisees contracted to pay an initial franchise fee of $30,000. By December 31, 1991, each franchisee had paid a nonrefundable $10,000 fee and signed a note to pay $10,000 principal plus the market rate of interest on December 31, 1992, and December 31, 1993. Experience indicates that one franchisee will default on the additional payments. Services for the initial fee will be performed in 1992. What amount of net unearned franchise fees would Potter report at December 31, 1991?

a. $400,000
b. $600,000
c. $610,000
d. $630,000

1N91#29. Winn Co. sells subscriptions to a specialized directory that is published semiannually and shipped to subscribers on April 15 and October 15. Subscriptions received after the March 31 and September 30 cutoff dates are held for the next publication. Cash from subscribers is received evenly during the year and is credited to deferred subscription revenue. Data relating to 1990 are as follows:

Deferred subscription revenue, 1/1/90	$ 750,000
Cash receipts from subscribers	3,600,000

In its December 31, 1990, balance sheet, Winn should report deferred subscription revenue of
a. $2,700,000
b. $1,800,000
c. $1,650,000
d. $ 900,000

1M91#40. On December 31, 1990, Rice, Inc. authorized Graf to operate as a franchisee for an initial franchise fee of $150,000. Of this amount, $60,000 was received upon signing the agreement and the balance, represented by a note, is due in three annual payments of $30,000 each beginning December 31, 1991. The present value on December 31, 1990, of the three annual payments appropriately discounted is $72,000. According to the agreement, the nonrefundable down payment represents a fair measure of the services already performed by Rice; however, substantial future services are required of Rice. Collectibility of the note is reasonably certain. In Rice's December 31, 1990, balance sheet, unearned franchise fees from Graf's franchise should be reported as
a. $132,000
b. $100,000
c. $ 90,000
d. $ 72,000

1M91#43. Aneen's Video Mart sells 1- and 2-year mail order subscriptions for its video-of-the-month business. Subscriptions are collected in advance and credited to sales. An analysis of the recorded sales activity revealed the following:

	1989	*1990*
Sales	$420,000	$500,000
Less cancellations	20,000	30,000
Net sales	$400,000	$470,000
Subscriptions expirations:		
1989	$120,000	
1990	155,000	$130,000
1991	125,000	200,000
1992		140,000
	$400,000	$470,000

In Aneen's December 31, 1990, balance sheet, the balance for unearned subscription revenue should be
a. $495,000
b. $470,000
c. $465,000
d. $340,000

1M91#44. On January 1, 1990, Hooks Oil Co. sold equipment with a carrying amount of $100,000, and a remaining useful life of 10 years, to Maco Drilling for $150,000. Hooks immediately leased the equipment back under a 10-year capital lease with a present value of $150,000 and will depreciate the equipment using the straight-line method. Hooks made the first annual lease payment of $24,412 in December 1990. In Hooks' December 31, 1990, balance sheet, the unearned gain on equipment sale should be
a. $50,000
b. $45,000
c. $25,588
d. $0

1N90#17. Ryan Co. sells major household appliance service contracts for cash. The service contracts are for a one-year, two-year, or three-year period. Cash receipts from contracts are credited to unearned service contract revenues. This account had a balance of $720,000 at December 31, 1989 before year-end adjustment. Service contract costs are charged as incurred to the service contract expense account, which had a balance of $180,000 at December 31, 1989. Outstanding service contracts at December 31, 1989 expire as follows:

During 1990	—	$150,000
During 1991	—	225,000
During 1992	—	100,000

What amount should be reported as unearned service contract revenues in Ryan's December 31, 1989 balance sheet?
a. $540,000
b. $475,000
c. $295,000
d. $245,000

1N90#18. Lane Co., which began operations on January 1, 1989, appropriately uses the installment method of accounting. The following information pertains to Lane's operations for the year 1989:

Installment sales	$1,000,000
Regular sales	600,000
Cost of installment sales	500,000
Cost of regular sales	300,000
General and administrative expenses	100,000
Collections on installment sales	200,000

The deferred gross profit account in Lane's December 31, 1989 balance sheet should be
a. $150,000
b. $320,000
c. $400,000
d. $500,000

1M90#31. On December 31, 1989, Bain Corp. sold a machine to Ryan and simultaneously leased it back for one year. Pertinent information at this date follows:

Sales price	$360,000
Carrying amount	330,000
Present value of reasonable lease rentals ($3,000 for 12 months @ 12%)	34,100
Estimated remaining useful life	12 years

In Bain's December 31, 1989 balance sheet, the deferred revenue from the sale of this machine should be

a. $34,100
b. $30,000
c. $ 4,100
d. $0

1N89#23. Karr Co. began operations on January 1, 1988 and appropriately uses the installment method of accounting. The following information pertains to Karr's operations for 1988:

Installment sales	$800,000
Cost of installment sales	480,000
General and administrative expenses	80,000
Collections on installment sales	300,000

The balance in the deferred gross profit account at December 31, 1988 should be

a. $120,000
b. $150,000
c. $200,000
d. $320,000

1M89#34. Dix Company sells magazine subscriptions for one- and two-year periods. Cash receipts from subscribers are credited to magazine subscriptions collected in advance. This account had a balance of $2,100,000 at December 31, 1988 before year-end adjustment. Outstanding subscriptions at December 31, 1988 expire as follows:

During 1989 — $600,000
During 1990 — 900,000

In its December 31, 1988 balance sheet, what amount should Dix report as the balance for magazine subscriptions collected in advance?

a. $2,100,000
b. $1,500,000
c. $1,050,000
d. $ 600,000

1M89#39. Rosson Corp., which began business on January 1, 1988, appropriately uses the installment sales method of accounting for income tax reporting purposes. The following data are available for 1988:

Installment accounts receivable, 12/31/88	$200,000
Installment sales for 1988	$350,000
Gross profit on sales	40%

Under the installment sales method, what would be Rosson's deferred gross profit at December 31, 1988?

a. $120,000
b. $ 90,000
c. $ 80,000
d. $ 60,000

1N88#20. At December 31, 1987, Raft Boutique had 1,000 gift certificates outstanding, which had been sold to customers during 1987 for $70 each. Raft operates on a gross margin of 60% of its sales. What amount of revenue pertaining to the 1,000 outstanding gift certificates should be deferred at December 31, 1987?

a. $0
b. $28,000
c. $42,000
d. $70,000

1N88#21. On December 31, 1987, Parke Corp. sold Edlow Corp. an airplane with an estimated remaining useful life of ten years. At the same time, Parke leased back the airplane for three years. Additional information is as follows:

Sales price	$600,000
Carrying amount of airplane at date of sale	$100,000
Monthly rental under lease	$ 6,330
Interest rate implicit in the lease as computed by Edlow and known by Parke (this rate is lower than the lessee's incremental borrowing rate)	12%
Present value of operating lease rentals ($6,330 for 36 months @ 12%)	$190,581
The leaseback is considered an operating lease	

In Parke's December 31, 1987 balance sheet, what amount should be included as deferred revenue on this transaction?

a. $0
b. $190,581
c. $309,419
d. $500,000

1M88#32. On December 31, 1987, Ruhl Corp. sold equipment to Dorr and simultaneously leased it back for three years. The following data pertain to the transaction at this date:

Sales price	$220,000
Carrying amount	150,000
Present value of lease rentals ($2,000 for 36 months @ 12%)	60,800
Estimated remaining useful life	10 years

At December 31, 1987, what amount should Ruhl report as deferred revenue from the sale of the equipment?

a. $0
b. $ 9,200
c. $60,800
d. $70,000

C. Deferred Income Tax Liabilities

In February 1992, the FASB issued Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes,* superceding Statement of Financial Accounting Standards No. 96, *Accounting for Income Taxes.* Accordingly, future examinations will test knowledge of SFAS No. 109.

1M92#32. Rico Corp. owns 40% of Dee Corp.'s voting common stock and accounts for its investment using the equity method. During 1991, Dee reported earnings of $225,000 and paid dividends of $75,000. Rico assumes that all of Dee's undistributed earnings will be distributed as dividends in future years. Rico's income tax rate is 30%. Rico elected early application of FASB Statement No. 96, *Accounting for Income Taxes.* Ignoring the dividends received deduction, what amount of deferred income tax liability should Rico report in its 1991 financial statements?

a. $27,000
b. $18,000
c. $ 9,000
d. $0

1M92#33. Scott Corp. received cash of $20,000 that was included in revenues in its 1991 financial statements, of which $12,000 will not be taxable until 1992. Scott's enacted tax rate is 30% for 1991, and 25% for 1992. Scott elected early application of FASB Statement No. 96, *Accounting for Income Taxes.* What amount should Scott report in its 1991 balance sheet for deferred income tax liability?

a. $2,000
b. $2,400
c. $3,000
d. $3,600

1N91#30. Bart, Inc., a newly organized corporation, uses the equity method of accounting for its 30% investment in Rex Co.'s common stock. During 1990, Rex paid dividends of $300,000 and reported earnings of $900,000. In addition:

- The dividends received from Rex are eligible for the 80% dividends received deduction.
- All the undistributed earnings of Rex will be distributed in future years.
- There are no other temporary differences.
- Bart's 1990 income tax rate is 30%.
- The enacted income tax rate after 1990 is 25%.

Bart elected early application of FASB Statement No. 96, *Accounting for Income Taxes.* In Bart's December 31, 1990, balance sheet, the deferred income tax liability should be

a. $10,800
b. $ 9,000
c. $ 5,400
d. $ 4,500

1N91#32. Lake Corp., a newly organized company, reported pretax financial income of $100,000 for 1990. Among the items reported in Lake's 1990 income statement are the following:

• Premium on officer's life insurance with Lake as owner and beneficiary	$15,000
• Interest received on municipal bonds	20,000

Lake elected early application of FASB Statement No. 96, *Accounting for Income Taxes.* The enacted tax rate for 1990 is 30% and 25% thereafter. In its December 31, 1990, balance sheet, Lake should report a deferred income tax liability of

a. $28,500
b. $ 4,500
c. $ 3,750
d. $0

1N91#35. In its 1990 income statement, Tow, Inc. reported proceeds from an officer's life insurance policy of $90,000 and depreciation of $250,000. Tow was the owner and beneficiary of the life insurance on its officer. Tow deducted depreciation of $370,000 in its 1990 income tax return when the tax rate was 30%. Data related to the reversal of the excess tax deduction for depreciation follow:

Year	*Reversal of excess tax deduction*	*Enacted tax rates*
1991	$50,000	35%
1992	40,000	35%
1993	20,000	25%
1994	10,000	25%

There are no other temporary differences. Tow elected early application of FASB Statement No. 96, *Accounting for Income Taxes.* In its December 31, 1990, balance sheet, what amount should Tow report as a deferred income tax liability?

a. $36,000
b. $39,000
c. $63,000
d. $66,000

1N91#38. Mill, which began operations on January 1, 1988, recognizes income from long-term construction contracts under the percentage-of-completion method in its financial statements and under the completed contract method for income tax reporting. Income under each method follows:

Year	*Completed contract*	*Percentage-of-completion*
1988	$ —	$300,000
1989	400,000	600,000
1990	700,000	850,000

The income tax rate was 30% for 1988 through 1990. For years after 1990, the enacted tax rate is 25%. There are no other temporary differences. Mill elected early application of FASB Statement No. 96, *Accounting for Income Taxes*. Mill should report in its December 31, 1990, balance sheet, a deferred income tax liability of

a. $ 87,500
b. $105,000
c. $162,500
d. $195,000

1M91#41. On June 30, 1990, Ank Corp. prepaid a $19,000 premium on an annual insurance policy. The premium payment was a tax deductible expense in Ank's 1990 cash basis tax return. The accrual basis income statement will report a $9,500 insurance expense in 1990 and 1991.

Ank elected early application of FASB Statement No. 96, *Accounting for Income Taxes*. Ank's income tax rate is 30% in 1990 and 25% thereafter. In Ank's December 31, 1990, balance sheet, what amount related to the insurance should be reported as a deferred income tax liability?

a. $5,700
b. $4,750
c. $2,850
d. $2,375

1N90#19. In its 1989 income statement, Noll Corp. reported depreciation of $400,000 and interest revenue on municipal obligations of $60,000. Noll reported depreciation of $550,000 on its 1989 income tax return. The difference in depreciation is the only temporary difference, and it will reverse equally over the next three years. Noll's enacted income tax rates are 35% for 1989, 30% for 1990 and 25% for 1991 and 1992. Noll elected early application of FASB Statement No. 96, *Accounting for Income Taxes*. What amount should be included in the deferred income tax liability in Noll's December 31, 1989 balance sheet?

a. $40,000
b. $52,500
c. $63,000
d. $73,500

1N90#20. Cory, Inc. uses the accrual method of accounting for financial reporting purposes and appropriately uses the installment method of accounting for income tax purposes. Installment income of $250,000 will be collected in the following years when the enacted tax rates are:

	Collection of income	*Enacted tax rates*
1989	$ 25,000	35%
1990	50,000	30%
1991	75,000	30%
1992	100,000	25%

The installment income is Cory's only temporary difference. Cory elected early application of FASB Statement No. 96, *Accounting for Income Taxes*. What amount should be included in the deferred income tax liability in Cory's December 31, 1989 balance sheet?

a. $62,500
b. $71,250
c. $78,750
d. $87,500

1M90#28. Tell Corp.'s 1989 income statement had pretax financial income of $38,000 in its first year of operations. Tell uses an accelerated cost recovery method on its tax return and straight-line depreciation for financial reporting.

The differences between the book and tax deductions for depreciation over the five-year life of the assets acquired in 1989, and the enacted tax rates for 1989 to 1993 are as follows:

	Book over (under) tax	*Tax rates*
1989	(8,000)	35%
1990	(13,000)	30%
1991	(3,000)	30%
1992	10,000	25%
1993	14,000	25%

There are no other temporary differences. Tell elected early application of FASB Statement No. 96, *Accounting for Income Taxes*. In Tell's December 31, 1989 balance sheet, the gross noncurrent deferred income tax liability and the income taxes currently payable should be

	Gross noncurrent deferred income tax liability	*Income taxes currently payable*
a.	$6,000	$ 7,500
b.	$6,000	$10,500
c.	$4,800	$ 9,000
d.	$4,800	$10,500

1M90#32. Tara Corp. uses the equity method of accounting for its 40% investment in Flax, Inc.'s common stock. During 1989, Flax reported earnings of $750,000 and paid dividends of $250,000. Assume that:

- All the undistributed earnings of Flax will be distributed as dividends in future periods.
- The dividends received from Flax are eligible for the 80% dividends received deduction.
- There are no other temporary differences.
- Tara's 1989 income tax rate is 30%.
- Enacted income tax rates after 1989 are 25%.

Tara elected early application of FASB Statement No. 96, *Accounting for Income Taxes*. In its December 31, 1989 balance sheet, the increase in the deferred income tax liability from the above transactions would be

a. $10,000
b. $12,000
c. $15,000
d. $18,000

1M90#34. Huff Corp. began operations on January 1, 1988. Huff recognizes revenues from all sales under the accrual method for financial reporting purposes and appropriately uses the installment method for income tax purposes. Huff's gross margin on installment sales under each method was as follows:

Year	*Accrual method*	*Installment method*
1988	$ 800,000	$300,000
1989	1,300,000	700,000

Huff elected early application of FASB Statement No. 96, *Accounting for Income Taxes*. Enacted income tax rates are 30% for 1989 and 25% thereafter. There are no other temporary differences. In Huff's December 31, 1989 balance sheet, the deferred income tax liability should be

a. $150,000
b. $180,000
c. $275,000
d. $330,000

1N89#24. Frey Corp., a construction company, appropriately uses the completed contract method of accounting for income tax purposes. However, Frey uses the percentage-of-completion accounting method for financial statement purposes. Pertinent data at December 31, 1988, the close of Frey's first year of operations, are:

Date contract began	*Estimated completion date*	*Income recognized in 1988 on each contract*
3/1/88	9/1/89	$600,000
6/1/88	12/1/89	300,000
9/1/88	3/1/90	200,000
12/1/88	6/1/90	100,000

Frey's enacted income tax rates are 30% for 1988, 25% for 1989 and 20% for 1990. Frey elected early application of FASB Statement No. 96, *Accounting for Income Taxes,* in its financial statements for the year ended December 31, 1988. What amount should be included in the deferred income tax liability at December 31, 1988 for these transactions?

a. $360,000
b. $330,000
c. $285,000
d. $240,000

1N89#26. On December 2, 1988, Huff Corp. received a condemnation award of $450,000 as compensation for the forced sale of land purchased five years earlier for $300,000. The gain was not reported as taxable income on its income tax return for the year ended December 31, 1988, because Huff elected to replace the land within the allowed replacement period for at least $450,000. Huff has an income tax rate of 25% for 1988, and there is an enacted rate of 30% for years ending after 1988. There were no other temporary differences. Huff elected early application of FASB Statement No. 96, *Accounting for Income Taxes.* In its December 31, 1988 balance sheet, Huff should report a deferred income tax liability of

a. $135,000
b. $ 45,000
c. $ 37,500
d. $0

1M89#37. On January 1, 1988, Lum, Inc. purchased a machine for $90,000 which will be depreciated $9,000 per year for financial statement reporting. For income tax reporting, Lum elected to expense $10,000 and to use straight-line depreciation which will allow a cost recovery deduction of $8,000 for 1988. Lum uses the liability method to account for temporary differences. Assume a present and future enacted income tax rate of 30%. What amount should be added to Lum's deferred income tax liability for this temporary difference at December 31, 1988?

a. $5,400
b. $3,000
c. $2,700
d. $2,400

1M89#40. On January 1, 1988, Lundy Corp. purchased 40% of the voting common stock of Glen, Inc. and appropriately accounts for its investment by the equity method. During 1988, Glen reported earnings of $225,000 and paid dividends of $75,000. Lundy assumes that all of Glen's undistributed earnings will be distributed as dividends in future periods when the enacted tax rate will be 30%. Ignore the dividend-received deduction. Lundy's current enacted income tax rate is 25%. Lundy uses the liability method to account for temporary differences. The increase in Lundy's deferred income tax liability for this temporary difference is

a. $45,000
b. $37,500
c. $27,000
d. $18,000

1M89#41. Lane, Inc., which began operations on January 1, 1986, recognizes income from construction-type contracts under the percentage-of-completion method in its financial statements. Lane appropriately uses the completed contract method for income tax reporting. Reported income from construction-type contracts under each method is as follows:

Year	*Percentage-of-completion*	*Completed contract*
1986	$ 600,000	$ —
1987	1,200,000	800,000
1988	1,700,000	1,400,000

For all of the above years and years to 1991 the enacted income tax rate is 30%, and there are no other tem-

porary differences. At December 31, 1988, using the liability method, Lane should report a liability for deferred taxes of
a. $ 90,000
b. $210,000
c. $300,000
d. $390,000

1M89#42. Among the items reported on Cord, Inc.'s income statement for the year ended December 31, 1988 were the following:

Amortization of goodwill	$10,000
Insurance premium on life of an officer with Cord as owner and beneficiary	5,000

Temporary differences amount to
a. $0
b. $ 5,000
c. $10,000
d. $15,000

D. Capitalized Lease Liability

1M92#34. Robbins, Inc. leased a machine from Ready Leasing Co. The lease qualifies as a capital lease and requires 10 annual payments of $10,000 beginning immediately. The lease specifies an interest rate of 12% and a purchase option of $10,000 at the end of the tenth year, even though the machine's estimated value on that date is $20,000. Robbins' incremental borrowing rate is 14%.

The present value of an annuity due of 1 at:
12% for 10 years is 6.328
14% for 10 years is 5.946

The present value of 1 at:
12% for 10 years is .322
14% for 10 years is .270

What amount should Robbins record as lease liability at the beginning of the lease term?
a. $62,160
b. $64,860
c. $66,500
d. $69,720

1N91#33. On December 31, 1990, Day Co. leased a new machine from Parr with the following pertinent information:

Lease term	6 years
Annual rental payable at beginning of each year	$50,000
Useful life of machine	8 years
Day's incremental borrowing rate	15%
Implicit interest rate in lease (known by Day)	12%
Present value of an annuity of 1 in advance for 6 periods at	
12%	4.61
15%	4.35

The lease is not renewable, and the machine reverts to Parr at the termination of the lease. The cost of the machine on Parr's accounting records is $375,500. At the beginning of the lease term, Day should record a lease liability of
a. $375,500
b. $230,500
c. $217,500
d. $0

1N91#34. On December 31, 1989, Adam Co. leased a machine under a capital lease for a period of ten years, contracting to pay $50,000 on signing the lease and $50,000 annually on December 31 of the next nine years. The present value at December 31, 1989, of the ten lease payments over the lease term discounted at 10% was $338,000. At December 31, 1990, Adam's total capital lease liability is
a. $303,980
b. $266,800
c. $259,200
d. $243,000

1M91#42. On January 1, 1990, Babson, Inc. leased two automobiles for executive use. The lease requires Babson to make five annual payments of $13,000 beginning January 1, 1990. At the end of the lease term, December 31, 1994, Babson guarantees the residual value of the automobiles will total $10,000. The lease qualifies as a capital lease. The interest rate implicit in the lease is 9%. Present value factors for the 9% rate implicit in the lease are as follows:

For an annuity due with 5 payments	4.240
For an ordinary annuity with 5 payments	3.890
Present value of $1 for 5 periods	0.650

Babson's recorded capital lease liability immediately after the first required payment should be
a. $48,620
b. $44,070
c. $35,620
d. $31,070

1M91#45. On January 1, 1990, Blaugh Co. signed a long-term lease for an office building. The terms of the lease required Blaugh to pay $10,000 annually, beginning December 30, 1990, and continuing each year for 30 years. The lease qualifies as a capital lease. On January 1, 1990, the present value of the lease payments is $112,500 at the 8% interest rate implicit in the lease. In Blaugh's December 31, 1990, balance sheet, the capital lease liability should be
a. $102,500
b. $111,500
c. $112,500
d. $290,000

1N90#21. On December 31, 1989, Neal, Inc. leased machinery with a fair value of $105,000 from Frey Rentals Co. The agreement is a six-year noncancelable lease requiring annual payments of $20,000 beginning December 31, 1989. The lease is appropriately accounted for by Neal as a capital lease. Neal's incremental borrowing rate is 11%. Neal knows the interest rate implicit in the lease payments is 10%.

- The present value of an annuity due of 1 for 6 years at 10% is 4.7908.
- The present value of an annuity due of 1 for 6 years at 11% is 4.6959.

In its December 31, 1989 balance sheet, Neal should report a lease liability of

a. $75,816
b. $85,000
c. $93,918
d. $95,816

1N90#22. On December 31, 1988, Roe Co. leased a machine from Colt for a five-year period. Equal annual payments under the lease are $105,000 (including $5,000 annual executory costs) and are due on December 31 of each year. The first payment was made on December 31, 1988, and the second payment was made on December 31, 1989. The five lease payments are discounted at 10% over the lease term. The present value of minimum lease payments at the inception of the lease and before the first annual payment was $417,000. The lease is appropriately accounted for as a capital lease by Roe. In its December 31, 1989 balance sheet, Roe should report a lease liability of

a. $317,000
b. $315,000
c. $285,300
d. $248,700

1M90#33. On December 31, 1988, Ball Co. leased a machine from Cook for a ten-year period expiring December 30, 1998. Annual payments of $100,000 are due on December 31. The first payment was made on December 31, 1988, and the second payment was made on December 31, 1989. The present value at the inception of the lease for the ten lease payments discounted at 10% was $676,000. The lease is appropriately accounted for as a capital lease by Ball. In its December 31, 1989 balance sheet, Ball should report a lease liability of

a. $643,600
b. $608,400
c. $533,600
d. $518,400

1M90#35. On January 1, 1989, Day Corp. entered into a 10-year lease agreement with Ward, Inc. for industrial equipment. Annual lease payments of $10,000 are payable at the end of each year. Day knows that the lessor expects a 10% return on the lease. Day has a 12% incremental borrowing rate. The equipment is expected to have an estimated useful life of 10 years. In addition, a third party has guaranteed to pay Ward a residual value of $5,000 at the end of the lease.

The present value of an ordinary annuity of $1 at

12% for 10 years is 5.6502
10% for 10 years is 6.1446

The present value of $1 at

12% for 10 years is .3220
10% for 10 years is .3855

In Day's October 31, 1989 balance sheet, the principal amount of the lease obligation was

a. $63,374
b. $61,446
c. $58,112
d. $56,502

1N89#22. On December 30, 1987, Bliss Corp. leased equipment under a capital lease for a period of 12 years, contracting to pay $100,000 annual rent on December 31, 1987 and on December 31 for each of the next 9 years. The capital lease liability was appropriately recorded at $681,600 on December 30, 1987 before the first payment. The useful life of the equipment coincided with the lease term. The interest rate implicit in the lease is 10%. In recording the December 31, 1988 payment, Bliss should reduce the capital lease liability by

a. $68,160
b. $58,160
c. $56,800
d. $41,840

1N89#27. On December 30, 1988, Haber Co. leased a new machine from Gregg Corp. The following data relate to the lease transaction at the inception of the lease:

Lease term	10 years
Annual rental payable at the end of each lease year	$100,000
Useful life of machine	12 years
Implicit interest rate	10%
Present value of an annuity of 1 in advance for 10 periods at 10%	6.76
Present value of annuity of 1 in arrears for 10 periods at 10%	6.15
Fair value of the machine	$700,000

The lease has no renewal option, and the possession of the machine reverts to Gregg when the lease terminates. At the inception of the lease, Haber should record a lease liability of

a. $0
b. $615,000
c. $630,000
d. $676,000

1M89#44. Beal, Inc. intends to lease a machine from Paul Corp. Beal's incremental borrowing rate is 14%. The prime rate of interest is 8%. Paul's implicit rate in the lease is 10%, which is known to Beal. Beal computes the present value of the minimum lease payments using

a. 8%
b. 10%
c. 12%
d. 14%

1N88#22. On January 2, 1987, Ashe Company entered into a ten-year noncancelable lease as lessee, requiring annual payments of $200,000 payable at the beginning of each year. Ashe's incremental borrowing rate is 14%, while the lessor's implicit interest rate, known to Ashe, is 12%. Present value factors of an annuity of 1 in advance for ten periods are 6.33 at 12%, and 5.95 at 14%. The leased property has an estimated useful life of 12 years. Ownership of the property remains with the lessor at expiration of the lease. At the inception of the lease, Ashe should record a lease liability of

a. $1,266,000
b. $1,190,000
c. $1,066,000
d. $0

1N88#29. On December 31, 1986, Evan Company leased a machine from Ryan for a ten-year period expiring December 30, 1996. Equal annual payments under the lease are $100,000 and are due on December 31 of each year. The first payment was made on December 31, 1986, and the second payment was made on December 31, 1987. The present value at December 31, 1986, of the ten lease payments over the lease term discounted at 10% was $676,000. The lease is appropriately accounted for as a capital lease by Evan. In its December 31, 1987 balance sheet, Evan should report a total lease liability of

a. $800,000
b. $643,600
c. $533,600
d. $518,400

1M88#35. On January 31, 1988, Clay Company leased a new machine from Saxe Corp. The following data relate to the lease transaction at the inception of the lease:

Lease term	10 years
Annual rental payable at beginning of each lease year	$ 50,000
Useful life of machine	15 years
Implicit interest rate	10%
Present value of an annuity of 1 in advance for 10 periods at 10%	6.76
Present value of annuity of 1 in arrears for 10 periods at 10%	6.15
Fair value of the machine	$400,000

The lease has no renewal option, and the possession of the machine reverts to Saxe when the lease terminates. At the inception of the lease, Clay should record a lease liability of

a. $400,000
b. $338,000
c. $307,500
d. $0

E. Bonds Payable

1M92#29. Dixon Co. incurred costs of $3,300 when it issued, on August 31, 1991, 5-year debenture bonds dated April 1, 1991. What amount of bond issue expense should Dixon report in its income statement for the year ended December 31, 1991?

a. $ 220
b. $ 240
c. $ 495
d. $3,300

1M92#30. The following information pertains to Camp Corp.'s issuance of bonds on July 1, 1991:

Face amount	$800,000
Term	10 years
Stated interest rate	6%
Interest payment dates	Annually on July 1
Yield	9%

	At 6%	*At 9%*
Present value of 1 for 10 periods	0.558	0.422
Future value of 1 for 10 periods	1.791	2.367
Present value of ordinary annuity of 1 for 10 periods	7.360	6.418

What should be the issue price for each $1,000 bond?

a. $1,000
b. $ 864
c. $ 807
d. $ 700

1N91#24. On September 1, 1991, Hall Corp. redeemed $500,000 of its 12%, 15-year bonds. Related unamortized bond premium and issue costs at that date were $8,000 and $10,000, respectively. What amount should Hall use to determine gain or loss on redemption?

a. $518,000
b. $508,000
c. $502,000
d. $498,000

1N91#28. On October 1, 1990, Brock, Inc. issued 200 of its 10%, $1,000 bonds at 101 plus accrued interest. The bonds are dated July 1, 1990, and mature on

July 1, 2000. Interest is payable semiannually on January 1 and July 1. At the time of issuance, Brock received cash of

a. $207,000
b. $205,000
c. $202,000
d. $197,000

1N91#36. On January 1, 1990, Celt Corp. issued 9% bonds in the face amount of $1,000,000, which mature on January 1, 2000. The bonds were issued for $939,000 to yield 10%, resulting in a bond discount of $61,000. Celt uses the interest method of amortizing bond discount. Interest is payable annually on December 31. At December 31, 1990, Celt's unamortized bond discount should be

a. $51,000
b. $51,610
c. $52,000
d. $57,100

1N91#37. Clay Corp. had $600,000 convertible 8% bonds outstanding at June 30, 1990. Each $1,000 bond was convertible into 10 shares of Clay's $50 par value common stock. On July 1, 1990, the interest was paid to bondholders, and the bonds were converted into common stock, which had a fair market value of $75 per share. The unamortized premium on these bonds was $12,000 at the date of conversion. Under the book value method, this conversion increased the following elements of the stockholders' equity section by

	Common stock	*Additional paid-in capital*
a.	$300,000	$312,000
b.	$306,000	$306,000
c.	$450,000	$162,000
d.	$600,000	$ 12,000

1M91#46. On December 31, 1990, Cobb issued 2,000 of its 10%, $1,000 bonds at 99. The issuance price established a bond discount of $20,000. In connection with the sale of these bonds, Cobb paid the following expenses:

Legal and accounting fees	$45,000
Printing of the prospectus	55,000
Underwriting fees	85,000

In Cobb's December 31, 1990, balance sheet, bond issue costs should be reported as

a. $120,000
b. $130,000
c. $160,000
d. $185,000

1M91#47. Hancock Co.'s December 31, 1990, balance sheet contained the following items in the long-term liabilities section:

Unsecured	
9.375% registered bonds ($25,000 maturing annually beginning in 1994)	$275,000
11.5% convertible bonds, callable beginning in 1999, due 2010	125,000
Secured	
9.875% guaranty security bonds, due 2010	$250,000
10.0% commodity backed bonds ($50,000 maturing annually beginning in 1995)	200,000

What are the total amounts of serial bonds and debenture bonds?

	Serial bonds	*Debenture bonds*
a.	$475,000	$400,000
b.	$475,000	$125,000
c.	$450,000	$400,000
d.	$200,000	$650,000

1N90#23. On March 1, 1990, Cain Corp. issued at 103 plus accrued interest, two hundred of its 9%, $1,000 bonds. The bonds are dated January 1, 1990 and mature on January 1, 2000. Interest is payable semiannually on January 1 and July 1. Cain paid bond issue costs of $10,000. Cain should realize net cash receipts from the bond issuance of

a. $216,000
b. $209,000
c. $206,000
d. $199,000

1N90#24. On June 30, 1990, Huff Corp. issued at 99, one thousand of its 8%, $1,000 bonds. The bonds were issued through an underwriter to whom Huff paid bond issue costs of $35,000. On June 30, 1990, Huff should report the bond liability at

a. $ 955,000
b. $ 990,000
c. $1,000,000
d. $1,025,000

1N90#25. On January 1, 1989, Wolf Corp. issued its 10% bonds in the face amount of $1,000,000, which mature on January 1, 1999. The bonds were issued for $1,135,000 to yield 8%, resulting in bond premium of $135,000. Wolf uses the interest method of amortizing bond premium. Interest is payable annually on December 31. At December 31, 1989, Wolf's adjusted unamortized bond premium should be

a. $135,000
b. $125,800
c. $121,500
d. $101,500

1N90#26. On April 1, 1989, Ward Corp. issued $750,000 of 10% nonconvertible bonds at 102 that are due on March 31, 1999. Each $1,000 bond was issued with 40 detachable stock warrants, each of which entitled the bondholder to purchase one share of Ward $10 par common stock for $25. On April 1, 1989, the market value of Ward's common stock was $20 per share, and the market value of each warrant was $4. What amount of the proceeds from the bond issue should Ward record as an increase in stockholders' equity?

a. $ 15,000
b. $120,000
c. $300,000
d. $750,000

1N90#27. On June 30, 1989, Town Co. had outstanding 8%, $2,000,000 face amount, 15-year bonds maturing on June 30, 1999. Interest is payable on June 30 and December 31. The unamortized balances in the bond discount and deferred bond issue costs accounts on June 30, 1989 were $70,000 and $20,000, respectively. On June 30, 1989, Town acquired all of these bonds at 94 and retired them. What net carrying amount should be used in computing gain or loss on this early extinguishment of debt?

a. $1,980,000
b. $1,930,000
c. $1,910,000
d. $1,880,000

1M90#36. On July 1, 1989, Howe Corp. issued 300 of its 10%, $1,000 bonds at 99 plus accrued interest. The bonds are dated April 1, 1989 and mature on April 1, 1999. Interest is payable semiannually on April 1 and October 1. What amount did Howe receive from the bond issuance?

a. $304,500
b. $300,000
c. $297,000
d. $289,500

1M90#37. During 1989, Eddy Corp. incurred the following costs in connection with the issuance of bonds:

Printing and engraving	$ 30,000
Legal fees	160,000
Fees paid to independent accountants for registration information	20,000
Commissions paid to underwriter	300,000

What amount should be recorded as a deferred charge to be amortized over the term of the bonds?

a. $510,000
b. $480,000
c. $300,000
d. $210,000

1M90#38. On January 1, 1989, Kay Inc. issued its 10% bonds in the face amount of $400,000, which mature on January 1, 1999. The bonds were issued for $354,000 to yield 12%, resulting in a bond discount of $46,000. Kay uses the interest method of amortizing bond discount. Interest is payable semiannually on July 1 and January 1. At June 30, 1989, Kay's unamortized bond discount would be

a. $46,000
b. $44,760
c. $43,700
d. $42,000

1M90#40. On January 1, 1984, Fox Corp. issued 1,000 of its 10%, $1,000 bonds for $1,040,000. These bonds were to mature on January 1, 1994 but were callable at 101 any time after December 31, 1987. Interest was payable semiannually on July 1 and January 1. On July 1, 1989, Fox called all of the bonds and retired them. Bond premium was amortized on a straight-line basis. Before income taxes, Fox's gain or loss in 1989 on this early extinguishment of debt was

a. $30,000 gain.
b. $12,000 gain.
c. $10,000 loss.
d. $ 8,000 gain.

1M90#42. On June 30, 1989, Hamm Corp. had outstanding $2,000,000 face amount of 8% convertible bonds maturing on June 30, 1994. Interest is payable on June 30 and December 31. Each $1,000 bond is convertible into 40 shares of Hamm's $20 par common stock. After amortization through June 30, 1989, the unamortized balance in the premium on bonds payable account was $50,000. On June 30, 1989, all of the bonds were converted when Hamm's common stock had a market price of $30 per share. Under the book value method, what amount should Hamm credit to additional paid-in capital in recording the conversion?

a. $350,000
b. $400,000
c. $450,000
d. $800,000

1N89#25. On January 1, 1989, Pine Corp. sold 200 of its 8%, $1,000 bonds at 97 plus accrued interest. The bonds are dated October 1, 1988 and mature on October 1, 1998. Interest is payable semiannually on April 1 and October 1. Accrued interest for the period October 1, 1988 to January 1, 1989 amounted to $4,000. On January 1, 1989, Pine should report bonds payable, net of discount, at

a. $196,000
b. $194,150
c. $194,000
d. $190,150

1N89#28. On May 1, Kreal Corp. issued $1,000,000, 20-year, 10% bonds for $1,075,000. Each $1,000 bond had a detachable warrant eligible for the purchase of one share of Kreal's $50 par value common stock for

$60. Immediately after the bonds were issued, Kreal's securities had the following market values:

10% bond without warrant	$1,050
Warrant	25
Common stock, $50 par value	65

What amount of the bond issue proceeds should Kreal record as an increase in stockholders' equity?
a. $50,000
b. $25,000
c. $ 5,000
d. $0

1N89#29. On January 1, 1989, Carrow, Inc. issued its 10% bonds in the face amount of $1,000,000 that mature on January 1, 1999. The bonds were issued for $886,000 to yield 12%, resulting in bond discount of $114,000. Carrow uses the interest method of amortizing bond discount. Interest is payable July 1 and January 1. For the six months ended June 30, 1989, Carrow should report bond interest expense at
a. $56,840
b. $55,700
c. $53,160
d. $50,000

1N89#30. Faber, Inc. had outstanding 10%, $1,000,000 face amount convertible bonds maturing on December 31, 1993, on which interest is paid June 30 and December 31. After amortization through June 30, 1989, the unamortized balance in the bond discount account was $30,000. On that date, all of these bonds were converted into 40,000 shares of $20 par value common stock. Faber incurred expenses of $10,000 in connection with the conversion. Recording the conversion by the book value (carrying amount) method, Faber should credit additional paid-in capital for
a. $160,000
b. $170,000
c. $180,000
d. $230,000

1N89#31. On February 1, 1986, Davis Corp. issued 12%, $1,000,000 face amount, 10-year bonds for $1,117,000. Davis reacquired all of these bonds at 102, plus accrued interest, on May 1, 1989 and retired them. Unamortized bond premium on that date was $78,000. Before income taxes, what was Davis' gain on the bond retirement?
a. $97,000
b. $58,000
c. $39,000
d. $19,000

1M89#45. On April 1, 1988, Fox, Inc. issued 400 of its 10%, $1,000 bonds at 97 plus accrued interest. The bonds are dated January 1, 1988 and mature on January 1, 1998. Interest is payable semiannually on January 1 and July 1. What amount of cash would Fox receive from the bond issuance?
a. $378,000
b. $388,000
c. $393,000
d. $398,000

1M89#47. On June 30, 1988, Eddy Corp. had outstanding 8%, $2,000,000 face amount convertible bonds maturing on June 30, 1998. Interest is payable on June 30 and December 31. Each $1,000 bond is convertible into 40 shares of Eddy's $20 par common stock. After amortization through June 30, 1988, the unamortized balance in the premium on bonds payable account was $50,000. On June 30, 1988, 1,000 bonds were converted when Eddy's common stock had a market price of $30 per share. Under the book value method, what amount should Eddy credit to additional paid-in capital in recording the conversion?
a. $425,000
b. $400,000
c. $225,000
d. $200,000

1M89#49. On July 1, 1982, Flax Corporation issued 2,000 of its 9%, $1,000 callable bonds for $1,920,000. The bonds are dated July 1, 1982 and mature on July 1, 1992. Interest is payable seminannually on January 1 and July 1. Flax uses the straight-line method of amortizing bond discount. The bonds can be called by the issuer at 101 at any time after June 30, 1987.

On July 1, 1988, Flax called in all of the bonds and retired them. Before income taxes, how much loss should Flax report on this early extinguishment of debt for the year ended December 31, 1988?
a. $ 20,000
b. $ 52,000
c. $ 68,000
d. $100,000

1N88#32. On March 1, 1988, Case Corp. issued $1,000,000 of 10% nonconvertible bonds at 103, due on February 28, 1998. Each $1,000 bond was issued with 30 detachable stock warrants, each of which entitled the holder to purchase, for $50, one share of Case common stock, par value $25. On March 1, 1988, the quoted market value of each warrant was $4. What amount of the bond issue proceeds should Case record as an increase in stockholders' equity?
a. $120,000
b. $ 90,000
c. $ 30,000
d. $0

1M88#37. On April 1, 1988, Greg Corp. issued, at 99 plus accrued interest, 200 of its 8%, $1,000 bonds. The bonds are dated January 1, 1988, mature on January 1, 1998, and pay interest on July 1 and January 1. Greg paid bond issue costs of $7,000. From the bond issuance, Greg received net cash of

a. $202,000
b. $198,000
c. $195,000
d. $191,000

1M88#38. On April 30, 1988, Witt Corp. had outstanding 8%, $1,000,000 face amount, convertible bonds maturing on April 30, 1992. Interest is payable on April 30 and October 31. On April 30, 1988, all these bonds were converted into 40,000 shares of $20 par common stock. On the date of conversion:

- Unamortized bond discount was $30,000.
- Each bond had a market price of $1,080.
- Each share of stock had a market price of $28.

Under the book value method, what amount should Witt record as a loss on conversion of bonds?

a. $150,000
b. $110,000
c. $ 30,000
d. $0

1M88#39. On May 1, 1988, Hill Corp. issued $2,000,000, 20-year, 10% bonds for $2,120,000. Each $1,000 bond had a detachable warrant eligible for the purchase of one share of Hill's $50 par common stock for $60. Immediately after bonds were issued, Hill's securities had the following market values:

10% bond without warrant	$1,040
Warrant	20
Common stock, $50 par	56

What amount should Hill credit to premium on bonds payable?

a. $120,000
b. $ 80,000
c. $ 40,000
d. $0

F. Contingent Liabilities and Commitments

1M92#35. During 1990, Gum Co. introduced a new product carrying a two-year warranty against defects. The estimated warranty costs related to dollar sales are 2% within 12 months following the sale and 4% in the second 12 months following the sale. Sales and actual warranty expenditures for the years ended December 31, 1990 and 1991, are as follows:

	Sales	*Actual warranty expenditures*
1990	$150,000	$2,250
1991	250,000	7,500
	$400,000	$9,750

What amount should Gum report as estimated warranty liability in its December 31, 1991, balance sheet?

a. $ 2,500
b. $ 4,250
c. $11,250
d. $14,250

1M92#36. On January 17, 1991, an explosion occurred at a Sims Co. plant causing extensive property damage to area buildings. Although no claims had yet been asserted against Sims by March 10, 1991, Sims' management and counsel concluded that it is likely that claims will be asserted and that it is reasonably possible Sims will be responsible for damages. Sims' management believed that $1,250,000 would be a reasonable estimate of its liability. Sims' $5,000,000 comprehensive public liability policy has a $250,000 deductible clause. In Sims' December 31, 1990, financial statements, which were issued on March 25, 1991, how should this item be reported?

a. As an accrued liability of $250,000.
b. As a footnote disclosure indicating the possible loss of $250,000.
c. As a footnote disclosure indicating the possible loss of $1,250,000.
d. No footnote disclosure or accrual is necessary.

1N91#39. East Corp. manufactures stereo systems that carry a two-year warranty against defects. Based on past experience, warranty costs are estimated at 4% of sales for the warranty period. During 1990, stereo system sales totaled $3,000,000, and warranty costs of $67,500 were incurred. In its income statement for the year ended December 31, 1990, East should report warranty expense of

a. $ 52,500
b. $ 60,000
c. $ 67,500
d. $120,000

1N90#28. Dunn Trading Stamp Co. records stamp service revenue and provides for the cost of redemptions in the year stamps are sold to licensees. Dunn's past experience indicates that only 80% of the stamps sold to licensees will be redeemed. Dunn's liability for stamp redemptions was $6,000,000 at December 31, 1988. Additional information for 1989 is as follows:

Stamp service revenue from stamps sold to licensees	$4,000,000
Cost of redemptions (stamps sold prior to 1/1/89)	2,750,000

If all the stamps sold in 1989 were presented for redemption in 1990, the redemption cost would be $2,250,000. What amount should Dunn report as a liability for stamp redemptions at December 31, 1989?

a. $7,250,000
b. $5,500,000
c. $5,050,000
d. $3,250,000

1M90#59. During 1989, Tedd Co. became involved in a tax dispute with the IRS. At December 31, 1989, Tedd's tax advisor believed that an unfavorable outcome was probable. A reasonable estimate of additional taxes was $400,000 but could be as much as $600,000. After the 1989 financial statements were issued, Tedd received and accepted an IRS settlement offer of $450,000. What amount of accrued liability should Tedd have reported in its December 31, 1989 balance sheet?

a. $400,000
b. $450,000
c. $500,000
d. $600,000

1M90#60. On November 25, 1989, an explosion occurred at a Rex Co. plant causing extensive property damage to area buildings. By March 10, 1990, claims had been asserted against Rex. Rex's management and counsel concluded that it is probable Rex will be responsible for damages, and that $3,500,000 would be a reasonable estimate of its liability. Rex's $10,000,000 comprehensive public liability policy has a $500,000 deductible clause. Rex's December 31, 1989 financial statements, issued on March 25, 1990, should report this item as

a. A footnote disclosure indicating the probable loss of $3,500,000.
b. An accrued liability of $3,500,000.
c. An accrued liability of $500,000.
d. A footnote disclosure indicating the probable loss of $500,000.

1N89#32. On November 10, 1988, a Garry Corp. truck was in an accident with an auto driven by Dacey. On January 10, 1989, Garry received notice of a lawsuit seeking $800,000 in damages for personal injuries suffered by Dacey. Garry Corp.'s counsel believes it is reasonably possible that Dacey will be awarded an estimated amount in the range between $250,000 and $500,000, and that $400,000 is a better estimate of potential liability than any other amount. Garry's accounting year ends on December 31, and the 1988 financial statements were issued on March 6, 1989. What amount of loss should Garry accrue at December 31, 1988?

a. $0
b. $250,000
c. $400,000
d. $500,000

1N89#33. In packages of its products, Curran Co. includes coupons that may be presented at retail stores to obtain discounts on other Curran products. Retailers are reimbursed for the face amount of coupons redeemed plus 10% of that amount for handling costs. Curran honors requests for coupon redemption by retailers up to three months after the consumer expiration date. Curran estimates that 70% of all coupons issued will ultimately be redeemed. Information relating to coupons issued by Curran during 1988 is as follows:

Consumer expiration date	12/31/88
Total face amount of coupons issued	$600,000
Total payments to retailers as of 12/31/88	220,000

What amount should Curran report as a liability for unredeemed coupons at December 31, 1988?

a. $0
b. $200,000
c. $242,000
d. $308,000

1M89#43. On December 31, 1988, Mith Co. was a defendant in a pending lawsuit. The suit arose from the alleged defect of a product that Mith sold in 1986. In the opinion of Mith's attorney, it is probable that Mith will have to pay $50,000, and it is reasonably possible that Mith will have to pay $60,000 as a result of this lawsuit. In its 1988 financial statements, Mith would report

a. An accrued liability of $50,000 only.
b. An accrued liability of $50,000 and would disclose a contingent liability of an additional $10,000.
c. An accrued liability of $60,000 only.
d. No information about this lawsuit.

1N88#25. In packages of its products, the Kent Food Company includes coupons which may be presented to grocers for discounts on certain products of Kent on or before a stated expiration date. The grocers are reimbursed when they send the coupons to Kent. In Kent's experience, 40% of such coupons are redeemed, and one month generally elapses between the date a grocer receives a coupon from a consumer and the date Kent receives it. During 1987, Kent issued two series of coupons as follows:

Issued of	*Total value*	*Consumer expiration date*	*Amount disbursed as of 12/31/87*
1/1/87	$100,000	6/30/87	$34,000
7/1/87	120,000	12/31/87	40,000

Kent's December 31, 1987 balance sheet should include a liability for unredeemed coupons of

a. $0
b. $ 8,000
c. $14,000
d. $48,000

1M88#41. On December 31, 1987, Beal Company was involved in a tax dispute with the IRS. Beal's tax counsel believed that an unfavorable outcome was probable and a reasonable estimate of additional taxes was $550,000, with a chance that the additional taxes could be as much as $850,000. After the 1987 financial statements were issued, Beal accepted an IRS settlement offer of $650,000. What amount of additional taxes should have been charged to income in 1987?

a. $850,000
b. $650,000
c. $550,000
d. $0

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock

2M92#1. On March 1, 1992, Rya Corp. issued 1,000 shares of its $20 par value common stock and 2,000 shares of its $20 par value convertible preferred stock for a total of $80,000. At this date, Rya's common stock was selling for $36 per share, and the convertible preferred stock was selling for $27 per share. What amount of the proceeds should be allocated to Rya's convertible preferred stock?

a. $60,000
b. $54,000
c. $48,000
d. $44,000

2N91#1. Of the 125,000 shares of common stock issued by Vey Corp., 25,000 shares were held as treasury stock at December 31, 1989. During 1990, transactions involving Vey's common stock were as follows:

January 1 through October 31 — 13,000 treasury shares were distributed to officers as part of a stock compensation plan.
November 1 — A 3-for-1 stock split took effect.
December 1 — Vey purchased 5,000 of its own shares to discourage an unfriendly takeover. These shares were not retired.

At December 31, 1990, how many shares of Vey's common stock were issued and outstanding?

	Shares	
	Issued	*Outstanding*
a.	375,000	334,000
b.	375,000	324,000
c.	334,000	334,000
d.	324,000	324,000

2N91#3. Hoyt Corp.'s current balance sheet reports the following stockholders' equity:

5% cumulative preferred stock, par value $100 per share; 2,500 shares issued and outstanding	$250,000
Common stock, par value $3.50 per share; 100,000 shares issued and outstanding	350,000
Additional paid-in capital in excess of par value of common stock	125,000
Retained earnings	300,000

Dividends in arrears on the preferred stock amount to $25,000. If Hoyt were to be liquidated, the preferred stockholders would receive par value plus a premium of $50,000. The book value per share of common stock is

a. $7.75
b. $7.50
c. $7.25
d. $7.00

2M91#4. The following accounts were among those reported on Luna Corp.'s balance sheet at December 31, 1990:

Marketable securities (market value $140,000)	$ 80,000
Preferred stock, $20 par value, 20,000 shares issued and outstanding	400,000
Additional paid-in capital on preferred stock	30,000
Retained earnings	900,000

On January 20, 1991, Luna exchanged all of the marketable securities for 5,000 shares of Luna's preferred stock. Market values at the date of the exchange were $150,000 for the marketable securities and $30 per share for the preferred stock. The 5,000 shares of preferred stock were retired immediately after the exchange. Which of the following journal entries should Luna record in connection with this transaction?

		Debit	*Credit*
a.	Preferred stock	$100,000	
	Additional paid-in capital on preferred stock	7,500	
	Retained earnings	42,500	
	Marketable securities		$80,000
	Gain on exchange of securities		70,000
b.	Preferred stock	100,000	
	Additional paid-in capital on preferred stock	30,000	
	Marketable securities		80,000
	Additional paid-in capital from retirement of preferred stock		50,000
c.	Preferred stock	150,000	
	Marketable securities		80,000
	Additional paid-in capital on preferred stock		70,000
d.	Preferred stock	150,000	
	Marketable securities		80,000
	Gain on exchange of securities		70,000

2N89#11. Seco Corp. was incorporated on January 2, 1988. The following information pertains to Seco's common stock transactions:

1988		
January 2	Number of shares authorized	80,000
February 1	Number of shares issued	60,000
July 1	Number of shares reacquired but **not** canceled	5,000
December 1	Two-for-one stock split	

At December 31, 1988, the number of shares of Seco's common stock outstanding is

a. 150,000
b. 120,000
c. 115,000
d. 110,000

2N89#12. In 1980, Rona Corp. issued 5,000 shares of $10 par value common stock for $100 per share. In 1988, Rona reacquired 2,000 of its shares at $150 per share from the estate of one of its deceased officers and immediately canceled these 2,000 shares. Rona uses the cost method in accounting for its treasury stock transactions. In connection with the retirement of these 2,000 shares, Rona should debit

	Additional paid-in capital	*Retained earnings*
a.	$ 20,000	$280,000
b.	$100,000	$180,000
c.	$180,000	$100,000
d.	$280,000	$0

1N88#48. At December 31, 1987, Tara Corp.'s stockholders' equity consisted of the following:

Preferred stock, $100 par, 10% noncumulative; 10,000 shares authorized, issued, and outstanding	$1,000,000
Common stock, $20 par; 100,000 shares authorized; 80,000 shares issued and outstanding	1,600,000
Retained earnings	600,000

The preferred stock has a liquidating value of $110 a share. At December 31, 1987, the book value per share of common stock is

a. $20.00
b. $22.00
c. $26.25
d. $27.50

1M88#42. Park Corp.'s stockholders' equity accounts at December 31, 1987 were as follows:

Common stock, $20 par	$8,000,000
Additional paid-in capital	2,550,000
Retained earnings	1,275,000

All shares of common stock outstanding at December 31, 1987 were issued in 1984 for $26 a share. On January 4, 1988, Park reacquired 20,000 shares of its common stock at $24 a share and retired them. Immediately after the shares were retired, the balance in additional paid-in capital would be

a. $2,430,000
b. $2,470,000
c. $2,510,000
d. $2,590,000

B. Additional Paid-in Capital

2M91#6. Earl was engaged by Farm Corp. to perform consulting services. Earl's compensation for these services consisted of 1,000 shares of Farm's $10 par value common stock, to be issued to Earl on completion of Earl's services. On the execution date of Earl's employment contract, Farm's stock had a market value of $40 per share. Six months later, when Earl's services were completed and the stock issued, the stock's market value was $50 per share. Farm's management estimated that Earl's services were worth $100,000 in cost savings to the company. As a result of this transaction, additional paid-in capital should increase by

a. $100,000
b. $ 90,000
c. $ 40,000
d. $ 30,000

1N88#28. Ashe Corp. was organized on January 1, 1987, with authorized capital of 100,000 shares of $20 par value common stock. During 1987 Ashe had the following transactions affecting stockholders' equity:

January 10	— Issued 25,000 shares at $22 a share.
March 25	— Issued 1,000 shares for legal services when the fair value was $24 a share.
September 30	— Issued 5,000 shares for a tract of land when the fair value was $26 a share.

What amount should Ashe report for additional paid-in capital at December 31, 1987?

a. $84,000
b. $80,000
c. $54,000
d. $50,000

C. Retained Earnings and Dividends

2M92#2. While preparing its 1991 financial statements, Dek Corp. discovered computational errors in its 1990 and 1989 depreciation expenses. These errors resulted in overstatement of each year's income by $25,000, net of income taxes. The following amounts were reported in the previously issued financial statements:

	1990	*1989*
Retained earnings, 1/1	$700,000	$500,000
Net income	150,000	200,000
Retained earnings, 12/31	$850,000	$700,000

Dek's 1991 net income is correctly reported at $180,000. Which of the following amounts should be reported as prior period adjustments and net income in Dek's 1991 and 1990 comparative financial statements?

	Year	*Prior period adjustment*	*Net income*
a.	1990	—	$150,000
	1991	($50,000)	180,000
b.	1990	($50,000)	$150,000
	1991	—	180,000
c.	1990	($25,000)	$125,000
	1991	—	180,000
d.	1990	—	$125,000
	1991	—	180,000

2M92#3. Bal Corp. declared a $25,000 cash dividend on May 8, 1991, to stockholders of record on May 23, 1991, payable on June 3, 1991. As a result of this cash dividend, working capital

a. Was **not** affected.
b. Decreased on June 3.
c. Decreased on May 23.
d. Decreased on May 8.

2M92#4. On December 1, 1991, Nilo Corp. declared a property dividend of marketable securities to be distributed on December 31, 1991, to stockholders of record on December 15, 1991. On December 1, 1991, the marketable securities had a carrying amount of $60,000 and a fair value of $78,000. What is the effect of this property dividend on Nilo's 1991 retained earnings, after all nominal accounts are closed?

a. $0.
b. $18,000 increase.
c. $60,000 decrease.
d. $78,000 decrease.

2M92#5. Ray Corp. declared a 5% stock dividend on its 10,000 issued and outstanding shares of $2 par value common stock, which had a fair value of $5 per share before the stock dividend was declared. This stock dividend was distributed 60 days after the declaration date. By what amount did Ray's current liabilities increase as a result of the stock dividend declaration?

a. $0
b. $ 500
c. $1,000
d. $2,500

2M92#6. The following information pertains to Meg Corp.:

- Dividends on its 1,000 shares of 6%, $10 par value cumulative preferred stock have not been declared or paid for 3 years.
- Treasury stock that cost $15,000 was reissued for $8,000.

What amount of retained earnings should be appropriated as a result of these items?

a. $0
b. $1,800
c. $7,000
d. $8,800

2N91#2. During 1990, Dale Corp. made the following accounting changes:

Method used in 1989	*Method used in 1990*	*After-tax effect*
Sum-of-the-years' digits depreciation	Straight-line depreciation	$30,000
Weighted-average for inventory valuation	First-in, first-out for inventory valuation	98,000

What amount should be classified in 1990 as prior period adjustments?

a. $0
b. $ 30,000
c. $ 98,000
d. $128,000

2N91#4. At December 31, 1990, Salo Corp.'s balance sheet accounts increased by the following amounts compared with those at the end of the prior year:

Assets	$178,000
Liabilities	54,000
Capital stock	120,000
Additional paid-in capital	12,000

The only charge to retained earnings during 1990 was for a dividend payment of $26,000. Net income for 1990 amounted to

a. $34,000
b. $26,000
c. $18,000
d. $ 8,000

2N91#5. Arp Corp.'s outstanding capital stock at December 15, 1990, consisted of the following:

- 30,000 shares of 5% cumulative preferred stock, par value $10 per share, fully participating as to dividends. No dividends were in arrears.
- 200,000 shares of common stock, par value $1 per share.

On December 15, 1990, Arp declared dividends of $100,000. What was the amount of dividends payable to Arp's common stockholders?

a. $10,000
b. $34,000
c. $40,000
d. $47,500

2N91#6. Ole Corp. declared and paid a liquidating dividend of $100,000. This distribution resulted in a decrease in Ole's

	Paid-in capital	*Retained earnings*
a.	No	No
b.	Yes	Yes
c.	No	Yes
d.	Yes	No

2M91#7. In 1989, Elm Corp. bought 10,000 shares of Oil Corp. at a cost of $20,000. On January 15, 1990, Elm declared a property dividend of the Oil stock to shareholders of record on February 1, 1990, payable on February 15, 1990. During 1990, the Oil stock had the following market values:

January 15	$25,000
February 1	26,000
February 15	24,000

The net effect of the foregoing transactions on retained earnings during 1990 should be a reduction of

a. $20,000
b. $24,000
c. $25,000
d. $26,000

2M91#12. The following stock dividends were declared and distributed by Sol Corp.:

Percentage of common shares outstanding at declaration date	*Fair value*	*Par value*
10	$15,000	$10,000
28	40,000	30,800

What aggregate amount should be debited to retained earnings for these stock dividends?

a. $40,800
b. $45,800
c. $50,000
d. $55,000

1N90#29. At December 31, 1989, Hull Corp. had the following marketable equity securities that were purchased during 1989, its first year of operations:

	Cost	*Market*	*Unrealized gain (loss)*
In Current Assets:			
Security A	$ 90,000	$60,000	$(30,000)
B	15,000	20,000	5,000
Totals	$105,000	$80,000	$(25,000)
In Noncurrent Assets:			
Security Y	$ 70,000	$ 80,000	$ 10,000
Z	90,000	45,000	(45,000)
Totals	$160,000	$125,000	$(35,000)

All market declines are considered temporary.

Valuation allowances at December 31, 1989 should be established with a corresponding charge against

	Income	*Stockholders' equity*
a.	$60,000	$0
b.	$30,000	$45,000
c.	$25,000	$35,000
d.	$25,000	$0

2N89#13. On July 1, 1988, Alto Corp. split its common stock 5 for 1 when the market value was $100 per share. Prior to the split, Alto had 10,000 shares of $10 par value common stock issued and outstanding. After the split, the par value of the stock

a. Remained at $10.
b. Was reduced to $8.
c. Was reduced to $5.
d. Was reduced to $2.

2N89#14. At December 31, 1987 and 1988, Tri Corp. had outstanding 2,000 shares of $100 par value 6% cumulative preferred stock and 10,000 shares of $10 par value common stock. At December 31, 1987, dividends in arrears on the preferred stock were $6,000. Cash dividends declared in 1988 totaled $22,000. What amounts were payable on each class of stock?

	Preferred stock	*Common stock*
a.	$12,000	$10,000
b.	$16,000	$ 6,000
c.	$18,000	$ 4,000
d.	$22,000	$0

2N89#15. The first examination of Rudd Corp.'s financial statements was made for the year ended December 31, 1988. The auditor found that Rudd had purchased another company in January 1986 and had recorded goodwill of $100,000 in connection with this purchase. It was determined that the goodwill had an estimated useful life of only five years because of obsolescence. No amortization of goodwill had ever been recorded. For the December 31, 1988 financial statements, Rudd should debit

	Amortization expense	*Retained earnings*
a.	$0	$100,000
b.	$20,000	$ 40,000
c.	$33,333	$0
d.	$60,000	$0

2M89#3. On May 1, 1989, Rhud Corp. declared and issued a 10% common stock dividend. Prior to this dividend, Rhud had 100,000 shares of $1 par value common stock issued and outstanding. The fair value of Rhud's common stock was $30 per share on May 1, 1989. As a result of this stock dividend, Rhud's total stockholders' equity

a. Increased by $300,000.
b. Decreased by $300,000.
c. Decreased by $10,000.
d. Did **not** change.

1N88#60. Bain Corp. owned 20,000 common shares of Tell Corp. purchased in 1983 for $180,000. On December 15, 1987, Bain declared a property dividend of all of its Tell Corp. shares on the basis of one share of Tell for every 10 shares of Bain common stock held by its stockholders. The property dividend was distributed on January 15, 1988. On the declaration date, the aggregate market price of the Tell shares held by Bain was $300,000. The entry to record the declaration of the dividend would include a debit to retained earnings (or property dividends declared) of

a. $0
b. $120,000
c. $180,000
d. $300,000

1M88#43. On January 5, 1988, Sardi Minerals Corp. declared a cash dividend of $600,000 to stockholders of record on January 21, 1988, and payable on February 11, 1988. The dividend is permissible under the laws of Sardi's state of incorporation. The following data pertain to 1987:

Net income for year ended 12/31/87	$190,000
Additional paid-in capital, 12/31/87	675,000
Retained earnings, 12/31/87	425,000

The $600,000 dividend includes a liquidating dividend of

a. $0
b. $175,000
c. $410,000
d. $485,000

D. Treasury Stock and Other Contra Accounts

2M92#7. The following information pertains to Lark Corp.'s long-term marketable equity securities portfolio:

	December 31,	
	1991	*1990*
Cost	$200,000	$200,000
Market value	240,000	180,000

Differences between cost and market values are considered to be temporary. The decline in market value was properly accounted for at December 31, 1990. By what amount should the contra account — unrealized loss on long-term marketable equity securities — decrease from December 31, 1990, to December 31, 1991?

a. $60,000
b. $40,000
c. $20,000
d. $0

2N91#7. In 1989, Seda Corp. acquired 6,000 shares of its $1 par value common stock at $36 per share. During 1990, Seda issued 3,000 of these shares at $50 per share. Seda uses the cost method to account for its treasury stock transactions. What accounts and amounts should Seda credit in 1990 to record the issuance of the 3,000 shares?

	Treasury stock	*Additional paid-in capital*	*Retained earnings*	*Common stock*
a.		$102,000	$42,000	$6,000
b.		$144,000		$6,000
c.	$108,000	$ 42,000		
d.	$108,000		$42,000	

2M89#6. At December 31, 1987, Rama Corp. had 20,000 shares of $1 par value treasury stock that had been acquired in 1987 at $12 per share. In May 1988, Rama issued 15,000 of these treasury shares at $10 per share. The cost method is used to record treasury stock transactions. Rama is located in a state where laws relating to acquisition of treasury stock restrict the availability of retained earnings for declaration of dividends. At December 31, 1988, what amount should Rama show in notes to financial statements as a restriction of retained earnings as a result of its treasury stock transactions?

a. $ 5,000
b. $10,000
c. $60,000
d. $90,000

1N88#44. Day Corp. holds 10,000 shares of its $10 par value common stock as treasury stock reacquired in 1986 for $120,000. On December 12, 1988, Day reissued all 10,000 shares for $190,000. Under the cost method of accounting for treasury stock, the reissuance would result in a credit to

a. Capital stock of $100,000.
b. Retained earnings of $70,000.
c. Gain on sale of investments of $70,000.
d. Additional paid-in capital of $70,000.

E. Stock Options, Warrants, and Rights

2M92#8. On July 1, 1991, Vail Corp. issued rights to stockholders to subscribe to additional shares of its common stock. One right was issued for each share owned. A stockholder could purchase one additional share for 10 rights plus $15 cash. The rights expired on September 30, 1991. On July 1, 1991, the market price of a share with the right attached was $40, while the market price of one right alone was $2. Vail's stockholders' equity on June 30, 1991, comprised the following:

Common stock, $25 par value, 4,000 shares issued and outstanding	$100,000
Additional paid-in capital	60,000
Retained earnings	80,000

By what amount should Vail's retained earnings decrease as a result of issuance of the stock rights on July 1, 1991?

a. $0
b. $ 5,000
c. $ 8,000
d. $10,000

2M91#5. Ray Corp. issued bonds with a face amount of $200,000. Each $1,000 bond contained detachable stock warrants for 100 shares of Ray's common stock. Total proceeds from the issue amounted to $240,000. The market value of each warrant was $2, and the market value of the bonds without the warrants was $196,000. The bonds were issued at a discount of

a. $0
b. $ 678
c. $ 4,000
d. $33,898

2M89#7. On January 1, 1987, Doro Corp. granted an employee an option to purchase 3,000 shares of Doro's $5 par value common stock at $20 per share. The option became exercisable on December 31, 1988, after the employee completed two years of service. The option was exercised on January 10, 1989. The market prices of Doro's stock were as follows:

January 1, 1987	$30
December 31, 1988	50
January 10, 1989	45

For 1988, Doro should recognize compensation expense of

a. $45,000
b. $37,500
c. $15,000
d. $0

1N88#41. On January 1, 1987, Ward Corp. granted stock options to corporate executives for the purchase of 20,000 shares of the company's $20 par value common stock at 80% of the market price on the exercise date, December 28, 1987. All stock options were exercised on December 28, 1987. The quoted market prices of Ward's $20 par value common stock were as follows:

January 1, 1987	$45
December 28, 1987	60

As a result of the exercise of the stock options and the issuance of the common stock, Ward should record a credit to additional paid-in capital of

a. $800,000
b. $740,000
c. $560,000
d. $500,000

F. Reorganization and Change in Entity

2M92#9. Wood Corp., a debtor-in-possession under Chapter 11 of the Federal Bankruptcy Code, granted an equity interest to a creditor in full settlement of a $28,000 debt owed to the creditor. At the date of this transaction, the equity interest had a fair value of $25,000. What amount should Wood recognize as an extraordinary gain on restructuring of debt?

a. $0
b. $ 3,000
c. $25,000
d. $28,000

2M92#10. Kamy Corp. is in liquidation under Chapter 7 of the Federal Bankruptcy Code. The bankruptcy trustee has established a new set of books for the bankruptcy estate. After assuming custody of the estate, the trustee discovered an unrecorded invoice of $1,000 for machinery repairs performed before the bankruptcy filing. In addition, a truck with a carrying amount of $20,000 was sold for $12,000 cash. This truck was bought and paid for in the year before the bankruptcy. What amount should be debited to estate equity as a result of these transactions?

a. $0
b. $1,000
c. $8,000
d. $9,000

2N91#8. Jay & Kay partnership's balance sheet at December 31, 1990, reported the following:

Total assets	$100,000
Total liabilities	20,000
Jay, capital	40,000
Kay, capital	40,000

On January 2, 1991, Jay and Kay dissolved their partnership and transferred all assets and liabilities to a newly formed corporation. At the date of incorporation, the fair value of the net assets was $12,000 more than the carrying amount on the partnership's books, of which $7,000 was assigned to tangible assets and $5,000 was assigned to goodwill. Jay and Kay were each issued 5,000 shares of the corporation's $1 par value common stock. Immediately following incorporation, additional paid-in capital in excess of par should be credited for

a. $68,000
b. $70,000
c. $77,000
d. $82,000

2N91#10. Beni Corp. purchased 100% of Carr Corp.'s outstanding capital stock for $430,000 cash. Immediately before the purchase, the balance sheets of both corporations reported the following:

	Beni	*Carr*
Assets	$2,000,000	$750,000
Liabilities	$ 750,000	$400,000
Common stock	1,000,000	310,000
Retained earnings	250,000	40,000
Liabilities and stockholders' equity	$2,000,000	$750,000

At the date of purchase, the fair value of Carr's assets was $50,000 more than the aggregate carrying amounts. In the consolidated balance sheet prepared immediately after the purchase, the consolidated stockholders' equity should amount to

a. $1,680,000
b. $1,650,000
c. $1,600,000
d. $1,250,000

2M91#13. On August 31, 1990, Wood Corp. issued 100,000 shares of its $20 par value common stock for the net assets of Pine, Inc., in a business combination accounted for by the purchase method. The market value of Wood's common stock on August 31 was $36 per share. Wood paid a fee of $160,000 to the consultant who arranged this acquisition. Costs of registering and issuing the equity securities amounted to $80,000. No goodwill was involved in the purchase. What amount should Wood capitalize as the cost of acquiring Pine's net assets?

a. $3,600,000
b. $3,680,000
c. $3,760,000
d. $3,840,000

2M91#14. Seco Corp. was forced into bankruptcy and is in the process of liquidating assets and paying claims. Unsecured claims will be paid at the rate of forty cents on the dollar. Hale holds a $30,000 noninterest-bearing note receivable from Seco collateralized by an asset with a book value of $35,000 and a liquidation value of $5,000. The amount to be realized by Hale on this note is

a. $ 5,000
b. $12,000
c. $15,000
d. $17,000

1N90#31. Kent Co. filed a voluntary bankruptcy petition on August 15, 1989, and the statement of affairs reflects the following amounts:

	Book value	*Estimated current value*
Assets:		
Assets pledged with fully secured creditors	$ 300,000	$370,000
Assets pledged with partially secured creditors	180,000	120,000
Free assets	420,000	320,000
	$ 900,000	$810,000
Liabilities:		
Liabilities with priority	$ 70,000	
Fully secured creditors	260,000	
Partially secured creditors	200,000	
Unsecured creditors	540,000	
	$1,070,000	

Assume that the assets are converted to cash at the estimated current values and the business is liquidated. What amount of cash will be available to pay unsecured nonpriority claims?

a. $240,000
b. $280,000
c. $320,000
d. $360,000

2N89#18. The December 31, 1988 condensed balance sheet of Mason & Gross, a partnership, follows:

Current assets	$125,000
Equipment (net)	15,000
Total assets	$140,000
Liabilities	$ 10,000
Mason, Capital	80,000
Gross, Capital	50,000
Total liabilities and capital	$140,000

Market values at December 31, 1988 are as follows:

Current assets	$90,000
Equipment	30,000
Liabilities	10,000

On January 2, 1989, the partnership was incorporated and 1,000 shares of $5 par value common stock were issued. What amount should be credited to additional contributed capital?

a. $0
b. $105,000
c. $125,000
d. $135,000

1N88#56. Howe, Inc. was organized to consolidate the resources of Ball Corp. and Cook Corp. in a business combination appropriately accounted for by the pooling of interests method. On January 1, 1988, Howe issued 60,000 shares of its $10 par value common stock for all of the outstanding capital stock of Ball and Cook. The equity account balances of Ball and Cook on this date were:

	Ball	*Cook*	*Total*
Par value of common stock	$150,000	$400,000	$550,000
Additional paid-in capital	30,000	85,000	115,000
Retained earnings	100,000	215,000	315,000
	$280,000	$700,000	$980,000

What is the balance in Howe's additional paid-in capital account immediately after the business combination?
a. $0
b. $ 65,000
c. $115,000
d. $380,000

1M88#44. Kent, Inc. has been forced into bankruptcy and has begun to liquidate. Unsecured claims will be paid at the rate of 40 cents on the dollar. Apex Co. holds a noninterest bearing note receivable from Kent in the amount of $100,000, collateralized by machinery with a liquidation value of $25,000. The total amount to be realized by Apex on this note receivable is
a. $25,000
b. $40,000
c. $55,000
d. $65,000

G. Partnerships

2N91#11. The partnership agreement of Axel, Berg & Cobb provides for the year-end allocation of net income in the following order:

- First, Axel is to receive 10% of net income up to $100,000 and 20% over $100,000.
- Second, Berg and Cobb each are to receive 5% of the remaining income over $150,000.
- The balance of income is to be allocated equally among the three partners.

The partnership's 1990 net income was $250,000 before any allocations to partners. What amount should be allocated to Axel?
a. $101,000
b. $103,000
c. $108,000
d. $110,000

2M91#1. Abel and Carr formed a partnership and agreed to divide initial capital equally, even though Abel contributed $100,000 and Carr contributed $84,000 in identifiable assets. Under the bonus approach to adjust the capital accounts, Carr's unidentifiable asset should be debited for
a. $46,000
b. $16,000
c. $ 8,000
d. $0

2M91#2. Dunn and Grey are partners with capital account balances of $60,000 and $90,000, respectively. They agree to admit Zorn as a partner with a one-third interest in capital and profits, for an investment of $100,000, after revaluing the assets of Dunn and Grey. Goodwill to the original partners should be
a. $0
b. $33,333
c. $50,000
d. $66,667

2M91#3. The partnership agreement of Reid and Simm provides that interest at 10% per year is to be credited to each partner on the basis of weighted-average capital balances. A summary of Simm's capital account for the year ended December 31, 1990, is as follows:

Balance, January 1	$140,000
Additional investment, July 1	40,000
Withdrawal, August 1	(15,000)
Balance, December 31	165,000

What amount of interest should be credited to Simm's capital account for 1990?
a. $15,250
b. $15,375
c. $16,500
d. $17,250

2N89#17. Gow and Cubb formed a partnership on March 1, 1989 and contributed the following assets:

	Gow	*Cubb*
Cash	$80,000	
Equipment (market value)		$50,000

The equipment was subject to a chattel mortgage of $10,000 that was assumed by the partnership. The partners agreed to share profits and losses equally. Cubb's capital account at March 1, 1989 should be
a. $40,000
b. $45,000
c. $50,000
d. $60,000

2N89#19. Blau and Rubi are partners who share profits and losses in the ratio of 6:4, respectively. On May 1, 1989, their respective capital accounts were as follows:

Blau	$60,000
Rubi	50,000

On that date, Lind was admitted as a partner with a one-third interest in capital and profits for an investment of $40,000. The new partnership began with total capital of $150,000. Immediately after Lind's admission, Blau's capital should be

a. $50,000
b. $54,000
c. $56,667
d. $60,000

2N89#20. Beck, the active partner in Beck & Cris, receives an annual bonus of 25% of partnership net income after deducting the bonus. For the year ended December 31, 1988, partnership net income before the bonus amounted to $300,000. Beck's 1988 bonus should be

a. $56,250
b. $60,000
c. $62,500
d. $75,000

2M89#5. The following condensed balance sheet is presented for the partnership of Axel, Barr, and Cain, who share profits and losses in the ratio of 4:3:3, respectively:

Cash	$100,000
Other assets	300,000
Total	$400,000
Liabilities	$150,000
Axel, capital	40,000
Barr, capital	180,000
Cain, capital	30,000
Total	$400,000

The partners agreed to dissolve the partnership after selling the other assets for $200,000. Upon dissolution of the partnership, Axel should have received

a. $0
b. $40,000
c. $60,000
d. $70,000

2M89#9. On May 1, 1989, Cobb and Mott formed a partnership and agreed to share profits and losses in the ratio of 3:7, respectively. Cobb contributed a parcel of land that cost him $10,000. Mott contributed $40,000 cash. The land was sold for $18,000 on May 1, 1989, immediately after formation of the partnership. What amount should be recorded in Cobb's capital account on formation of the partnership?

a. $18,000
b. $17,400
c. $15,000
d. $10,000

2M89#10. The partnership agreement of Donn, Eddy, and Farr provides for annual distribution of profit or loss in the following sequence:

- Donn, the managing partner, receives a bonus of 10% of profit.
- Each partner receives 6% interest on average capital investment.
- Residual profit or loss is divided equally.

Average capital investments for 1988 were:

Donn	$80,000
Eddy	50,000
Farr	30,000

What portion of the $100,000 partnership profit for 1988 should be allocated to Farr?

a. $28,600
b. $29,800
c. $35,133
d. $41,600

1N88
Items 26 and 27 are based on the following:

On June 30, 1988, the condensed balance sheet for the partnership of Eddy, Fox, and Grimm, together with their respective profit and loss sharing percentages, was as follows:

Assets, net of liabilities	$320,000
Eddy, capital (50%)	$160,000
Fox, capital (30%)	96,000
Grimm, capital (20%)	64,000
	$320,000

26. Eddy decided to retire from the partnership and by mutual agreement is to be paid $180,000 out of partnership funds for his interest. Total goodwill implicit in the agreement is to be recorded. After Eddy's retirement, what are the capital balances of the other partners?

	Fox	*Grimm*
a.	$ 84,000	$56,000
b.	$102,000	$68,000
c.	$108,000	$72,000
d.	$120,000	$80,000

27. Assume instead that Eddy remains in the partnership and that Hamm is admitted as a new partner with a 25% interest in the capital of the new partnership for a cash payment of $140,000. Total goodwill implicit in the transaction is to be recorded. Immediately after admission of Hamm, Eddy's capital account balance should be

a. $280,000
b. $210,000
c. $160,000
d. $140,000

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

A. Revenues and Gains

1M92#37. On October 1, 1991, Acme Fuel Co. sold 100,000 gallons of heating oil to Karn Co. at $3 per gallon. Fifty thousand gallons were delivered on December 15, 1991, and the remaining 50,000 gallons were delivered on January 15, 1992. Payment terms were: 50% due on October 1, 1991, 25% due on first delivery, and the remaining 25% due on second delivery. What amount of revenue should Acme recognize from this sale during 1991?

a. $ 75,000
b. $150,000
c. $225,000
d. $300,000

1M92#38. The following information pertains to Spee Co.'s 1991 sales:

Cash sales	
Gross	$40,000
Returns and allowances	2,000
Credit sales	
Gross	60,000
Discounts	3,000

On January 1, 1991, customers owed Spee $20,000. On December 31, 1991, customers owed Spee $15,000. Spee uses the direct writeoff method for bad debts. No bad debts were recorded in 1991. Under the cash basis of accounting, what amount of revenue should Spee report for 1991?

a. $100,000
b. $ 95,000
c. $ 85,000
d. $ 38,000

1M92#39. Zeta Co. reported sales revenue of $4,600,000 in its income statement for the year ended December 31, 1991. Additional information is as follows:

	12/31/90	12/31/91
Accounts receivable	$1,000,000	$1,300,000
Allowance for uncollectible accounts	(60,000)	(110,000)

Zeta wrote off uncollectible accounts totaling $20,000 during 1991. Under the cash basis of accounting, Zeta would have reported 1991 sales of

a. $4,900,000
b. $4,350,000
c. $4,300,000
d. $4,280,000

1M92#40. Sage, Inc. bought 40% of Adams Corp.'s outstanding common stock on January 2, 1991, for $400,000. The carrying amount of Adams' net assets at the purchase date totaled $900,000. Fair values and carrying amounts were the same for all items except for plant and inventory, for which fair values exceeded their carrying amounts by $90,000 and $10,000, respectively. The plant has an 18-year life. All inventory was sold during 1991. Goodwill, if any, is to be amortized over 40 years. During 1991, Adams reported net income of $120,000 and paid a $20,000 cash dividend. What amount should Sage report in its income statement from its investment in Adams for the year ended December 31, 1991?

a. $48,000
b. $42,000
c. $36,000
d. $32,000

1M92#41. Ace Co. sold to King Co. a $20,000, 8%, 5-year note that required five equal annual year-end payments. This note was discounted to yield a 9% rate to King. The present value factors of an ordinary annuity of $1 for five periods are as follows:

8%	3.992
9%	3.890

What should be the total interest revenue earned by King on this note?

a. $9,000
b. $8,000
c. $5,560
d. $5,050

1M92#43. Bort Co. purchased 2,000 shares of Crel Co. common stock on March 5, 1991, for $72,000. Bort received a $1,000 cash dividend on the Crel stock on July 15, 1991. Crel declared a 10% stock dividend on December 15, 1991, to stockholders of record as of December 31, 1991. The dividend was distributed on January 15, 1992. The market price of the stock was $38 on December 15, 1991, $40 on December 31, 1991, and $42 on January 15, 1992. What amount should Bort record as dividend revenue for the year ended December 31, 1991?

a. $1,000
b. $8,600
c. $9,000
d. $9,400

1M92#44. On January 1, 1991, Denver Corp. entered into a 4-year licensing agreement with Akins Co. allowing Akins to use Denver's cartoon characters on all the lunchboxes that Akins manufactures. Akins is required to pay Denver royalties equal to 10% of annual lunchbox sales. Akins guaranteed Denver a $120,000 minimum royalty over the life of the agreement and paid Denver the minimum amount on January 1, 1991. For the year ended December 31, 1991, Akins's lunchbox sales totaled $500,000. What amount of royalty income should Denver report in 1991?

a. $ 30,000
b. $ 50,000
c. $ 80,000
d. $120,000

1M92#45. On July 1, 1991, one of Rudd Co.'s delivery vans was destroyed in an accident. On that date, the van's carrying value was $2,500. On July 15, 1991, Rudd received and recorded a $700 invoice for a new engine installed in the van in May 1991, and another $500 invoice for various repairs. In August, Rudd received $3,500 under its insurance policy on the van, which it plans to use to replace the van. What amount should Rudd report as gain (loss) on disposal of the van in its 1991 income statement?

a. $1,000
b. $ 300
c. $0
d. $ (200)

1M92#46. Ocean Corp.'s comprehensive insurance policy allows its assets to be replaced at current value. The policy has a $50,000 deductible clause. One of Ocean's waterfront warehouses was destroyed in a winter storm. Such storms occur approximately every four years. Ocean incurred $20,000 of costs in dismantling the warehouse and plans to replace it. The following data relate to the warehouse:

Current carrying amount	$ 300,000
Replacement cost	1,100,000

What amount of gain should Ocean report as a separate component of income before extraordinary items?

a. $1,030,000
b. $ 780,000
c. $ 730,000
d. $0

1N91#31. On January 1, 1990, Dell, Inc. contracted with the city of Little to provide custom built desks for the city schools. The contract made Dell the city's sole supplier and required Dell to supply no less than 4,000 desks and no more than 5,500 desks per year for two years. In turn, Little agreed to pay a fixed price of $110 per desk. During 1990, Dell produced 5,000 desks for Little. At December 31, 1990, 500 of these desks were segregated from the regular inventory and were accepted and awaiting pickup by Little. Little paid Dell $450,000 during 1990. What amount should Dell recognize as contract revenue in 1990?

a. $450,000
b. $495,000
c. $550,000
d. $605,000

1N91#40. State Co. recognizes construction revenue and expenses using the percentage-of-completion method. During 1989, a single long-term project was begun, which continued through 1990. Information on the project follows:

	1989	*1990*
Accounts receivable from construction contract	$100,000	$300,000
Construction expenses	105,000	192,000
Construction in progress	122,000	364,000
Partial billings on contract	100,000	420,000

Profit recognized from the long-term construction contract in 1990 should be

a. $ 50,000
b. $108,000
c. $128,000
d. $228,000

1N91#41. On January 1, 1989, Mega Corp. acquired 10% of the outstanding voting stock of Penny, Inc. On January 2, 1990, Mega gained the ability to exercise significant influence over financial and operating control of Penny by acquiring an additional 20% of Penny's outstanding stock. The two purchases were made at prices proportionate to the value assigned to Penny's net assets, which equaled their carrying amounts. For the years ended December 31, 1989 and 1990, Penny reported the following:

	1989	*1990*
Dividends paid	$200,000	$300,000
Net income	600,000	650,000

In 1990, what amounts should Mega report as current year investment income and as an adjustment, before income taxes, to 1989 investment income?

	1990 investment income	*Adjustment to 1989 investment income*
a.	$195,000	$160,000
b.	$195,000	$100,000
c.	$195,000	$ 40,000
d.	$105,000	$ 40,000

1N91#42. Cap Corp. reported accrued investment interest receivable of $38,000 and $46,500 at January 1 and December 31, 1990, respectively. During 1990, cash collections from the investments included the following:

Capital gains distributions	$145,000
Interest	152,000

What amount should Cap report as interest revenue from investments for 1990?

a. $160,500
b. $153,500
c. $152,000
d. $143,500

1N91#43. During 1990, Colt Co. experienced financial difficulties and is likely to default on a $1,000,000, 15%, 3-year note dated January 1, 1989, payable to Cain National Bank. On December 31, 1990, the bank agreed to settle the note and unpaid 1990 interest of $150,000 for $820,000 cash payable on January 31, 1991. What is the amount of gain, before income taxes, from the debt restructuring?

a. $0
b. $150,000
c. $180,000
d. $330,000

1N91#44. In 1990, Neil Co. held the following investments in common stock:

- 25,000 shares of B & K, Inc.'s 100,000 outstanding shares. Neil's level of ownership gives it the ability to exercise significant influence over the financial and operating policies of B & K.
- 6,000 shares of Amal Corp.'s 309,000 outstanding shares.

During 1990, Neil received the following distributions from its common stock investments:

November 6 — $30,000 cash dividend from B & K.

November 11 —$1,500 cash dividend from Amal.

December 26 —3% common stock dividend from Amal. The closing price of this stock on a national exchange was $15 per share.

What amount of dividend revenue should Neil report for 1990?

a. $ 1,500
b. $ 4,200
c. $31,500
d. $34,200

1N91#46. On September 1, 1990, Cano & Co., a U.S. corporation, sold merchandise to a foreign firm for 250,000 francs. Terms of the sale require payment in francs on February 1, 1991. On September 1, 1990, the spot exchange rate was $.20 per franc. At December 31, 1990, Cano's year end, the spot rate was $.19, but the rate increased to $.22 by February 1, 1991, when payment was received. How much should Cano report as foreign exchange gain or loss in its 1991 income statement?

a. $0.
b. $2,500 loss.
c. $5,000 gain.
d. $7,500 gain.

1N91#49. Seldin Co. owns a royalty interest in an oil well. The contract stipulates that Seldin will receive royalty payments semiannually on January 31 and July 31. The January 31 payment will be for 20% of the oil sold to jobbers between the previous June 1 and November 30, and the July 31 payment will be for oil sold between the previous December 1 and May 31. Royalty receipts for 1990 amounted to $80,000 and $100,000 on January 31 and July 31, respectively. On December 31, 1989, accrued royalty revenue receivable amounted to $15,000. Production reports show the following oil sales:

June 1, 1989 — November 30, 1989	$400,000
December 1, 1989 — May 31, 1990	500,000
June 1, 1990 — November 30, 1990	425,000
December 1, 1990 — December 31, 1990	70,000

What amount should Seldin report as royalty revenue for 1990?

a. $179,000
b. $180,000
c. $184,000
d. $194,000

1N91#52. In 1985, May Corp. acquired land by paying $75,000 down and signing a note with a maturity value of $1,000,000. On the note's due date, December 31, 1990, May owed $40,000 of accrued interest and $1,000,000 principal on the note. May was in financial difficulty and was unable to make any payments. May and the bank agreed to amend the note as follows:

- The $40,000 of interest due on December 31, 1990, was forgiven.
- The principal of the note was reduced from $1,000,000 to $950,000 and the maturity date extended 1 year to December 31, 1991.
- May would be required to make one interest payment totaling $30,000 on December 31, 1991.

As a result of the troubled debt restructuring, May should report a gain, before taxes, in its 1990 income statement of

a. $40,000
b. $50,000
c. $60,000
d. $90,000

1N91#58. On August 1, 1990, Metro, Inc. leased a luxury apartment unit to Klum. The parties signed a 1-year lease beginning September 1, 1990, for a $1,000 monthly rent payable on the first day of the month. At the August 1 signing date, Metro collected $540 as a nonrefundable fee for allowing Klum to sign a 1-year lease (the normal lease term is three years) and $1,000 rent for September. Klum has made timely payments each month, but prepaid January's rent on December 20. In Metro's 1990 income statement, rent revenue should be reported as

a. $4,000
b. $4,180
c. $4,540
d. $5,180

1M91#48. Marr Corp. reported rental revenue of $2,210,000 in its cash basis federal income tax return for the year ended November 30, 1990. Additional information is as follows:

Rents receivable — November 30, 1990	$1,060,000
Rents receivable — November 30, 1989	800,000
Uncollectible rents written off during the fiscal year	30,000

Under the accrual basis, Marr should report rental revenue of

a. $1,920,000
b. $1,980,000
c. $2,440,000
d. $2,500,000

1M91#49. Barr Corp. started a long-term construction project in 1990. The following data relate to this project:

Contract price	$4,200,000
Costs incurred in 1990	1,750,000
Estimated costs to complete	1,750,000
Progress billings	900,000
Collections on progress billings	800,000

The project is accounted for by the percentage of completion method of accounting. In Barr's 1990 income statement, what amount of gross profit should be reported for this project?

a. $350,000
b. $150,000
c. $133,333
d. $100,000

1M91#50. The following information pertains to a sale of real estate by Ryan Co. to Sud Co. on December 31, 1989:

Carrying amount		$2,000,000
Sales price:		
Cash	$ 300,000	
Purchase money mortgage	2,700,000	3,000,000

The mortgage is payable in nine annual installments of $300,000 beginning December 31, 1990, plus interest of 10%. The December 31, 1990, installment was paid as scheduled, together with interest of $270,000. Ryan uses the cost recovery method to account for the sale. What amount of income should Ryan recognize in 1990 from the real estate sale and its financing?

a. $570,000
b. $370,000
c. $270,000
d. $0

1M91#52. Huff Co. acquired 30% of the voting common stock of Flax, Inc. on January 1, 1990, for $100,000. Huff has the ability to exercise significant influence over operating and financial policies of Flax. During 1990, Flax earned $40,000 and paid dividends of $25,000. Before income taxes, Huff should include what amount in its 1990 income statement pertaining to this investment?

a. $40,000
b. $25,000
c. $12,000
d. $ 7,500

1M91#53. Tara Co. owns an office building and leases the offices under a variety of rental agreements involving rent paid in advance monthly or annually. Not all tenants make timely payments of their rent. Tara's balance sheets contained the following data:

	1989	*1990*
Rentals receivable	$ 9,600	$12,400
Unearned rentals	32,000	24,000

During 1990, Tara received $80,000 cash from tenants. What amount of rental revenue should Tara record for 1990?

a. $90,800
b. $85,200
c. $74,800
d. $69,200

1N90#32. In November and December 1989, Dorr Co., a newly organized magazine publisher, received $72,000 for 1,000 three-year subscriptions at $24 per year, starting with the January 1990 issue. Dorr elected to include the entire $72,000 in its 1989 income tax return. What amount should Dorr report in its 1989 income statement for subscriptions revenue?

a. $0
b. $ 4,000
c. $24,000
d. $72,000

1N90#33. Winn Co. manufactures equipment that is sold or leased. On December 31, 1989, Winn leased equipment to Bart for a five-year period ending December 31, 1994, at which date ownership of the leased asset will be transferred to Bart. Equal payments under the lease are $22,000 (including $2,000 executory costs) and are due on December 31 of each year. The first payment was made on December 31, 1989. Collectibility of the remaining lease payments is reasonably assured, and Winn has no material cost uncertainties. The normal sales price of the equipment is $77,000, and cost is $60,000. For the year ended December 31, 1989, what amount of income should Winn realize from the lease transaction?

a. $17,000
b. $22,000
c. $23,000
d. $33,000

1N90#34. On January 1, 1988, Rex Co. sold a used machine to Lake, Inc. for $525,000. On this date, the machine had a depreciated cost of $367,500. Lake paid

$75,000 cash on January 1, 1988 and signed a $450,000 note bearing interest at 10%. The note was payable in three annual installments of $150,000 beginning January 1, 1989. Rex appropriately accounted for the sale under the installment method. Lake made a timely payment of the first installment on January 1, 1989 of $195,000, which included interest of $45,000 to date of payment. At December 31, 1989, Rex has deferred gross profit of

a. $105,000
b. $ 99,000
c. $ 90,000
d. $ 76,500

1N90#35. On January 1, 1988, Mill Co. exchanged equipment for a $200,000 noninterest bearing note due on January 1, 1991. The prevailing rate of interest for a note of this type at January 1, 1988 was 10%. The present value of $1 at 10% for three periods is 0.75. What amount of interest revenue should be included in Mill's 1989 income statement?

a. $0
b. $15,000
c. $16,500
d. $20,000

1N90#36. Day Co. received dividends from its common stock investments during the year ended December 31, 1989 as follows:

- A stock dividend of 400 shares from Parr Corp. on July 25, 1989 when the market price of Parr's shares was $20 per share. Day owns less than 1% of Parr's common stock.

- A cash dividend of $15,000 from Lark Corp. in which Day owns a 25% interest. A majority of Lark's directors are also directors of Day.

What amount of dividend revenue should Day report in its 1989 income statement?

a. $23,000
b. $15,000
c. $ 8,000
d. $0

1N90#37. On January 1, 1989, Wren Co. leased a building to Brill under an operating lease for ten years at $50,000 per year, payable the first day of each lease year. Wren paid $15,000 to a real estate broker as a finder's fee. The building is depreciated $12,000 per year. For 1989, Wren incurred insurance and property tax expense totaling $9,000. Wren's net rental income for 1989 should be

a. $27,500
b. $29,000
c. $35,000
d. $36,500

1N90#38. On November 15, 1989, Celt, Inc., a U.S. company, ordered merchandise FOB shipping point from an East German company for 200,000 marks. The merchandise was shipped and invoiced to Celt on December 10, 1989. Celt paid the invoice on January 10, 1990. The spot rates for marks on the respective dates are as follows:

November 15, 1989	$.4955
December 10, 1989	.4875
December 31, 1989	.4675
January 10, 1990	.4475

In Celt's December 31, 1989 income statement, the foreign exchange gain is

a. $9,600
b. $8,000
c. $4,000
d. $1,600

1N90#39. Adam Corp. had the following infrequent transactions during 1989:

- A $190,000 gain on reacquisition and retirement of bonds.

- A $260,000 gain on the disposal of a segment of a business. Adam continues similar operations at another location.

- A $90,000 loss on the abandonment of equipment.

In its 1989 income statement, what amount should Adam report as total infrequent net gains that are **not** considered extraordinary?

a. $100,000
b. $170,000
c. $360,000
d. $450,000

2N90#6. Amar Farms produced 300,000 pounds of cotton during the 1989 season. Amar sells all of its cotton to Brye Co., which has agreed to purchase Amar's entire production at the prevailing market price. Recent legislation assures that the market price will not fall below $.70 per pound during the next two years. Amar's costs of selling and distributing the cotton are immaterial and can be reasonably estimated. Amar reports its inventory at expected exit value. During 1989, Amar sold and delivered to Brye 200,000 pounds at the market price of $.70. Amar sold the remaining 100,000 pounds during 1990 at the market price of $.72. What amount of revenue should Amar recognize in 1989?

a. $140,000
b. $144,000
c. $210,000
d. $216,000

2N90#15. Gow Constructors, Inc. has consistently used the percentage-of-completion method of recognizing income. In 1989, Gow started work on an

$18,000,000 construction contract that was completed in 1990. The following information was taken from Gow's 1989 accounting records:

Progress billings	$6,600,000
Costs incurred	5,400,000
Collections	4,200,000
Estimated costs to complete	10,800,000

What amount of gross profit should Gow have recognized in 1989 on this contract?

a. $1,400,000
b. $1,200,000
c. $ 900,000
d. $ 600,000

2N90#20. During 1989, property owned by Arp Co. was acquired by the city in connection with a condemnation proceeding, resulting in a payment of $100,000 to Arp. The property's carrying amount was $70,000. Arp paid $45,000 in 1989 for replacement property. In Arp's income statement for the year ended December 31, 1989, what amount of gain should be reported on this involuntary conversion, disregarding income tax considerations?

a. $0
b. $15,000
c. $25,000
d. $30,000

1M90
Items 6 through 8* are based on the following:

Lee, Inc. acquired 30% of Polk Corp.'s voting stock on January 1, 1988 for $100,000. During 1988, Polk earned $40,000 and paid dividends of $25,000. Lee's 30% interest in Polk gives Lee the ability to exercise significant influence over Polk's operating and financial policies. During 1989, Polk earned $50,000 and paid dividends of $15,000 on April 1 and $15,000 on October 1. On July 1, 1989, Lee sold half of its stock in Polk for $66,000 cash.

6. Before income taxes, what amount should Lee include in its 1988 income statement as a result of the investment?

a. $40,000
b. $25,000
c. $12,000
d. $ 7,500

8. What should be the gain on sale of this investment in Lee's 1989 income statement?

a. $16,000
b. $13,750
c. $12,250
d. $10,000

*The item omitted can be found in other Content Specification Groups.

1M90#44. On October 20, 1989, Grimm Co. consigned 40 freezers to Holden Co. for sale at $1,000 each and paid $800 in transportation costs. On December 30, 1989, Holden reported the sale of 10 freezers and remitted $8,500. The remittance was net of the agreed 15% commission. What amount should Grimm recognize as consignment sales revenue for 1989?

a. $ 7,700
b. $ 8,500
c. $ 9,800
d. $10,000

1M90#45. On December 31, 1988, Mill Co. sold construction equipment to Drew, Inc. for $1,800,000. The equipment had a carrying amount of $1,200,000. Drew paid $300,000 cash on December 31, 1988 and signed a $1,500,000 note bearing interest at 10%, payable in five annual installments of $300,000. Mill appropriately accounts for the sale under the installment method. On December 31, 1989, Drew paid $300,000 principal and $150,000 interest. For the year ended December 31, 1989, what total amount of revenue should Mill recognize from the construction equipment sale and financing?

a. $250,000
b. $150,000
c. $120,000
d. $100,000

1M90#46. On July 1, 1989, Pell Co. purchased Green Corp. ten-year, 8% bonds with a face amount of $500,000 for $420,000. The bonds mature on June 30, 1997 and pay interest semiannually on June 30 and December 31. Using the interest method, Pell recorded bond discount amortization of $1,800 for the six months ended December 31, 1989. From this long-term investment, Pell should report 1989 revenue of

a. $16,800
b. $18,200
c. $20,000
d. $21,800

1M90#47. Simpson Co. received dividends from its common stock investments during the year ended December 31, 1989 as follows:

- A cash dividend of $8,000 from Wren Corp., in which Simpson owns a 2% interest.
- A cash dividend of $45,000 from Brill Corp., in which Simpson owns a 30% interest. This investment is appropriately accounted for using the equity method.
- A stock dividend of 500 shares from Paul Corp. was received on December 15, 1989, when the quoted market value of Paul's shares was $10 per share. Simpson owns less than 1% of Paul's common stock.

In Simpson's 1989 income statement, dividend revenue should be

a. $58,000
b. $53,000
c. $13,000
d. $ 8,000

1M90#48. Rapp Co. leased a new machine to Lake Co. on January 1, 1989. The lease expires on January 1, 1994. The annual rental is $90,000. Additionally, on January 1, 1989, Lake paid $50,000 to Rapp as a lease bonus and $25,000 as a security deposit to be refunded upon expiration of the lease. In Rapp's 1989 income statement, the amount of rental revenue should be

a. $140,000
b. $125,000
c. $100,000
d. $ 90,000

2M90#41. During 1988, Mitchell Corp. started a construction job with a total contract price of $600,000. The job was completed on December 15, 1989. Additional data are as follows:

	1988	*1989*
Actual costs incurred	$225,000	$255,000
Estimated remaining costs	225,000	—
Billed to customer	240,000	360,000
Received from customer	200,000	400,000

Under the completed contract method, what amount should Mitchell recognize as gross profit for 1989?

a. $ 45,000
b. $ 72,000
c. $ 80,000
d. $120,000

2M90#44. Certain balance sheet accounts of a foreign subsidiary of Rowan, Inc., at December 31, 1989, have been translated into U.S. dollars as follows:

	Translated at	
	Current rates	*Historical rates*
Note receivable, long-term	$240,000	$200,000
Prepaid rent	85,000	80,000
Patent	150,000	170,000
	$475,000	$450,000

The subsidiary's functional currency is the currency of the country in which it is located. What total amount should be included in Rowan's December 31, 1989 consolidated balance sheet for the above accounts?

a. $450,000
b. $455,000
c. $475,000
d. $495,000

2M90#45. Bolte Corp. had the following infrequent gains during 1989:

- $210,000 on reacquisition and retirement of bonds.
- $75,000 on repayment at maturity of a long-term note denominated in a foreign currency.
- $240,000 on sale of a plant facility (Bolte continues similar operations at another location.)

In its 1989 income statement, what amount should Bolte report as total infrequent gains which are **not** considered extraordinary?

a. $450,000
b. $315,000
c. $285,000
d. $240,000

2M90#57. Mill Construction Co. uses the percentage-of-completion method of accounting. During 1989, Mill contracted to build an apartment complex for Drew for $20,000,000. Mill estimated that total costs would amount to $16,000,000 over the period of construction. In connection with this contract, Mill incurred $2,000,000 of construction costs during 1989. Mill billed and collected $3,000,000 from Drew in 1989. What amount should Mill recognize as gross profit for 1989?

a. $250,000
b. $375,000
c. $500,000
d. $600,000

1N89#34. Peg Co. leased equipment from Howe Corp. on July 1, 1988 for an eight-year period expiring June 30, 1996. Equal payments under the lease are $600,000 and are due on July 1 of each year. The first payment was made on July 1, 1988. The rate of interest contemplated by Peg and Howe is 10%. The cash selling price of the equipment is $3,520,000, and the cost of the equipment on Howe's accounting records is $2,800,000. The lease is appropriately recorded as a sales-type lease. What is the amount of profit on the sale and interest revenue that Howe should record for the year ended December 31, 1988?

	Profit on sale	*Interest revenue*
a.	$720,000	$176,000
b.	$720,000	$146,000
c.	$ 45,000	$176,000
d.	$ 45,000	$146,000

1N89#35. On October 1, 1988, Price Corp., a real estate developer, sold land to Greene Co. for $5,000,000. Greene paid $600,000 cash and signed a 10-year $4,400,000 note bearing interest at 12%. The carrying amount of the land was $4,000,000 on date of sale. The note was payable in forty quarterly principal installments of $110,000 beginning January 2, 1989. Price appropriately accounts for the sale under the cost recovery method. On January 2, 1989, Greene paid the first principal installment of $110,000 and interest of $132,000. For the year ended December 31, 1988, what total amount of income should Price recognize from the land sale and financing?

a. $0
b. $120,000
c. $132,000
d. $252,000

1N89#36. John Tracey, M.D., keeps his accounting records on the cash basis. During 1988, Dr. Tracey collected $150,000 in fees from his patients. At December 31, 1987, Dr. Tracey had accounts receivable of $20,000. At December 31, 1988, Dr. Tracey had accounts receivable of $35,000 and unearned fees of $5,000. On the accrual basis, how much was Dr. Tracey's patient service revenue for 1988?

a. $130,000
b. $160,000
c. $165,000
d. $170,000

1N89#37. On January 1, 1988, Dyer Co. acquired as a long-term investment a 20% common stock interest in Eason Co. Dyer paid $700,000 for this investment when the fair value of Eason's net assets was $3,500,000. Dyer can exercise significant influence over Eason's operating and financial policies. For the year ended December 31, 1988, Eason reported net income of $400,000 and declared and paid cash dividends of $160,000. How much revenue from this investment should Dyer report for 1988?

a. $ 32,000
b. $ 48,000
c. $ 80,000
d. $112,000

1N89#38. On January 1, 1988, Jaffe Co. leased a machine to Pender Co. for ten years, with $10,000 payments due at the beginning of each year effective at the inception of the lease. The machine cost Jaffe $55,000. The lease is appropriately accounted for as a sales-type lease by Jaffe. The present value of the ten rent payments over the lease term discounted appropriately at 10% was $67,600. The estimated salvage value of the machine at the end of ten years is equal to the disposal costs. How much interest revenue should Jaffe record from the lease for the year ended December 31, 1988?

a. $5,500
b. $5,760
c. $6,760
d. $7,020

1N89#39. Albert Co. acquired 4,000 shares of Nolan, Inc. common stock on October 20, 1986 for $66,000. On November 30, 1988, Nolan distributed a 10% common stock dividend when the market price of the stock was $25 per share. On December 20, 1988, Albert sold 400 shares of its Nolan stock for $10,600. For the year ended December 31, 1988, how much should Albert report as dividend revenue?

a. $10,600
b. $10,000
c. $ 4,600
d. $0

1N89#40. On January 2, 1988, Osborn Co. assigned its patent to Aile for royalties of 10% of patent related sales. On the same date, Osborn received a $40,000 advance to be applied against royalties for 1988 sales. Royalties are payable every six months. Aile reported the following sales:

Six months ended	*Amount*
June 30, 1988	$150,000
December 31, 1988	200,000

How much royalty revenue should Osborn report in its 1988 income statement?

a. $75,000
b. $60,000
c. $40,000
d. $35,000

1N89#41. On January 3, 1986, Falk Co. purchased 500 shares of Milo Corp. common stock for $36,000. On December 2, 1988, Falk received 500 stock rights from Milo. Each right entitles the holder to acquire one share of stock for $85. The market price of Milo's stock was $100 a share immediately before the rights were issued, and $90 a share immediately after the rights were issued. Falk sold its rights on December 3, 1988 for $10 a right. Falk's gain from the sale of the rights is

a. $0
b. $1,000
c. $1,400
d. $5,000

1N89#43. On April 8, 1987, Day Corp. purchased merchandise from an unaffiliated foreign company for 10,000 units of the foreign company's local currency. Day paid the bill in full on March 1, 1988 when the spot rate was $.45. The spot rate was $.60 on April 8, 1987 and was $.55 on December 31, 1987. For the year ended December 31, 1988, Day should report a transaction gain of

a. $1,500
b. $1,000
c. $ 500
d. $0

1N89#44. On January 2, 1987, Troast Co. purchased as a long-term investment 10,000 shares of Lawton Corp. common stock for $70 per share, which represents a 1% interest. On December 31, 1987, the market price of the stock was $75 per share. On December 20, 1988, Troast needed additional cash for operations and sold all 10,000 shares of Lawton's stock for $100 per share. Troast's income tax rate was 30% for 1988. For the year ended December 31, 1988, Troast should report on its income statement a gain on disposal of

a. $300,000
b. $250,000
c. $210,000
d. $175,000

1M89#11. Lindy, a U.S. corporation, bought inventory items from a supplier in West Germany on November 5, 1987 for 100,000 marks, when the spot rate was $.4295. At Lindy's December 31, 1987 year end, the spot rate was $.4245. On January 15, 1988, Lindy bought 100,000 marks at the spot rate of $.4345 and paid the invoice. How much should Lindy report in its income statements for 1987 and 1988 as foreign exchange gain or (loss)?

	1987	*1988*
a.	$ 500	($1,000)
b.	$0	($ 500)
c.	($ 500)	$0
d.	($1,000)	$ 500

1M89#50. Greg Corp. reported revenue of $1,250,000 in its accrual basis income statement for the year ended June 30, 1989. Additional information was as follows:

Accounts receivable June 30, 1988	$400,000
Accounts receivable June 30, 1989	530,000
Uncollectible accounts written off during the fiscal year	15,000

Under the cash basis, Greg should report revenue of
a. $ 835,000
b. $ 850,000
c. $1,105,000
d. $1,135,000

1M89#51. On January 2, 1988, Rex Enterprises, Inc. authorized Adam Company to operate as a franchisee over a 20-year period for an initial franchise fee of $60,000 received on signing the agreement. Adam started operations on June 30, 1988, by which date Rex had performed all of the required initial services. In its income statement for the six months ended June 30, 1988, what amount should Rex report as revenue from franchise fees in connection with Adam's franchise?
a. $0
b. $ 1,500
c. $30,000
d. $60,000

1M89#53. Zach Company assigns some of its patents to other enterprises under a variety of licensing agreements. In some instances, advance royalties are received when the agreements are signed and, in others, royalties are remitted within 60 days after each license year end. The following data are included in Zach's December 31 balance sheets:

	1987	*1988*
Royalties receivable	$90,000	$85,000
Unearned royalties	60,000	40,000

During 1988, Zach received royalty remittances of $200,000. In its income statement for the year ended December 31, 1988, Zach should report royalty revenue of
a. $225,000
b. $215,000
c. $205,000
d. $195,000

1M89#54. On January 1, 1988, Post Corp. leased a warehouse to Winn under an operating lease for ten years at $60,000 per year, payable the first day of each lease year. Post paid $27,000 to a real estate broker as a finder's fee. The warehouse is depreciated $15,000 per year. For 1988, Post incurred insurance and property tax expense totaling $12,000. Post's net rental income for 1988 should be
a. $33,000
b. $30,300
c. $21,000
d. $ 6,000

1M89#59. On January 1, 1987, Tone Company exchanged equipment for a $200,000 noninterest bearing note due on January 1, 1990. The prevailing rate of interest for a note of this type at January 1, 1987 was 10%. The present value of $1 at 10% for three periods is 0.75. What amount of interest revenue should be included in Tone's 1988 income statement?
a. $ 7,500
b. $15,000
c. $16,500
d. $20,000

1N88#31. On October 1, 1987, Yost Corp. acquired for cash all of the voting common stock of Leer, Inc. The purchase price of Leer's stock equaled the book value and fair value of Leer's net assets. The separate net income for each company, excluding Yost's share of income from Leer, was as follows:

	Yost	*Leer*
Twelve months ended 12/31/87	$1,500,000	$900,000
Three months ended 12/31/87	165,000	150,000

During September, Leer paid $450,000 in dividends to its stockholders. For the year ended December 31, 1987, Yost Corp. issued parent-company-only financial statements. These statements are not considered to be those of the primary reporting entity. Under the equity method, what is the amount of net income reported in Yost's income statement?
a. $2,400,000
b. $1,950,000
c. $1,725,000
d. $1,650,000

1N88#33. In its accrual basis income statement for the year ended December 31, 1987, Glen Corp. reported revenue of $1,550,000. Additional information was as follows:

Accounts receivable — December 31, 1986	$350,000
Accounts receivable — December 31, 1987	$550,000

Under the cash basis, how much should Glen report as revenue for 1987?
a. $1,000,000
b. $1,200,000
c. $1,350,000
d. $1,750,000

1N88#34. Lewis Company's usual sales terms are net 60 days, F.O.B. shipping point. Sales, net of returns and allowances, totaled $2,300,000 for the year ended December 31, 1987, before year-end adjustments. Additional data are as follows:

- On December 27, 1987, Lewis authorized a customer to return, for full credit, goods shipped and billed at $50,000 on December 15, 1987. The returned goods were received by Lewis on January 4, 1988, and a $50,000 credit memo was issued and recorded on the same date.
- Goods with an invoice amount of $80,000 were billed and recorded on January 3, 1988. The goods were shipped on December 30, 1987.
- Goods with an invoice amount of $100,000 were billed and recorded on December 30, 1987. The goods were shipped on January 3, 1988.

Lewis' adjusted net sales for 1987 should be

a. $2,330,000
b. $2,280,000
c. $2,250,000
d. $2,230,000

1N88#35. Hill Company began operations on January 1, 1987, and appropriately uses the installment method of accounting. Data available for 1987 are as follows:

Installment accounts receivable, 12/31/87	$500,000
Installment sales	900,000
Cost of goods sold, as percentage of sales	60%

Using the installment method, Hill's realized gross profit for 1987 would be

a. $360,000
b. $240,000
c. $200,000
d. $160,000

1N88#36. On January 1, 1986, Mill Company sold a building and received as consideration $100,000 cash and a $400,000 noninterest bearing note due on January 1, 1989. There was no established exchange price for the building, and the note had no ready market. The prevailing rate of interest for a note of this type at January 1, 1986, was 10%. The present value of $1 at 10% for three periods is 0.75. What amount of interest revenue should be included in Mill's 1987 income statement?

a. $44,000
b. $40,000
c. $33,333
d. $33,000

1N88#37. Dix Company acquired 2,000 shares of Lane, Inc. common stock on October 5, 1985, at a cost of $44,000. On April 10, 1987, Lane distributed a 10% common stock dividend when the market price of the stock was $30 per share. On December 20, 1987, Dix sold 200 shares of its Lane stock for $6,400. For the year ended December 31, 1987, what amount should Dix report as dividend revenue?

a. $0
b. $2,400
c. $6,000
d. $6,400

1N88#38. On January 1, 1988, Ott Company sold goods to Fox Company. Fox signed a noninterest-bearing note requiring payment of $60,000 annually for seven years. The first payment was made on January 1, 1988. The prevailing rate of interest for this type of note at date of issuance was 10%. Information on present value factors is as follows:

Periods	*Present value of 1 at 10%*	*Present value of ordinary annuity of 1 at 10%*
6	.56	4.36
7	.51	4.87

Ott should record sales revenue in January 1988 of

a. $321,600
b. $292,200
c. $261,600
d. $214,200

1N88#40. On January 2, 1987, Shaw Company sold the copyright to a book to Poe Publishers, Inc. for royalties of 20% of future sales. On the same date, Poe paid Shaw a royalty advance of $100,000 to be applied against royalties for 1988 sales. On September 30, 1987, Poe made a $42,000 royalty remittance to Shaw for sales in the six-month period ended June 30, 1987. In January 1988, before issuance of its 1987 financial statements, Shaw learned that Poe's sales of the book totaled $250,000 for the last half of 1987. How much royalty revenue should Shaw report in its 1987 income statement?

a. $ 92,000
b. $142,000
c. $150,000
d. $192,000

1N88#42. During 1987, Kerr Company sold a parcel of land used as a plant site. The amount Kerr received was $100,000 in excess of the land's carrying amount. Kerr's income tax rate for 1987 was 30%. In its 1987 income statement, Kerr should report a gain on sale of land of

a. $0
b. $ 30,000
c. $ 70,000
d. $100,000

1M88#45. Tara Company reported revenue of $1,980,000 in its income statement for the year ended December 31, 1987. Additional information was as follows:

	12/31/86	*12/31/87*
Accounts receivable	$415,000	$550,000
Allowance for doubtful accounts	25,000	40,000

No uncollectible accounts were written off during 1987. Had the cash basis of accounting been used instead, Tara would have reported receipts for 1987 of

a. $2,115,000
b. $1,885,000
c. $1,860,000
d. $1,845,000

B. Expenses and Losses

1M92#47. The following balances were reported by Mall Co. at December 31, 1991 and 1990:

	12/31/91	*12/31/90*
Inventory	$260,000	$290,000
Accounts payable	75,000	50,000

Mall paid suppliers $490,000 during the year ended December 31, 1991. What amount should Mall report for cost of goods sold in 1991?

a. $545,000
b. $495,000
c. $485,000
d. $435,000

1M92#48. Pak Co.'s professional fees expense account had a balance of $82,000 at December 31, 1991, before considering year-end adjustments relating to the following:

- Consultants were hired for a special project at a total fee not to exceed $65,000. Pak has recorded $55,000 of this fee based on billings for work performed in 1991.
- The attorney's letter requested by the auditors dated January 28, 1992, indicated that legal fees of $6,000 were billed on January 15, 1992, for work performed in November 1991, and unbilled fees for December 1991 were $7,000.

What amount should Pak report for professional fees expense for the year ended December 31, 1991?

a. $105,000
b. $ 95,000
c. $ 88,000
d. $ 82,000

1M92#49. Hutch, Inc. uses the conventional retail inventory method to account for inventory. The following information relates to 1991 operations:

	Average	
	Cost	*Retail*
Beginning inventory and purchases	$600,000	$920,000
Net markups		40,000
Net markdowns		60,000
Sales		780,000

What amount should be reported as cost of sales for 1991?

a. $480,000
b. $487,500
c. $520,000
d. $525,000

1M92#50. South Co. purchased a machine that was installed and placed in service on January 1, 1990, at a cost of $240,000. Salvage value was estimated at $40,000. The machine is being depreciated over 10 years by the double-declining-balance method. For the year ended December 31, 1991, what amount should South report as depreciation expense?

a. $48,000
b. $38,400
c. $32,000
d. $21,600

1M92#51. West, Inc. made the following expenditures relating to Product Y:

- Legal costs to file a patent on Product Y — $10,000. Production of the finished product would not have been undertaken without the patent.
- Special equipment to be used solely for development of Product Y — $60,000. The equipment has no other use and has an estimated useful life of four years.
- Labor and material costs incurred in producing a prototype model — $200,000.
- Cost of testing the prototype — $80,000.

What is the total amount of costs that will be expensed when incurred?

a. $280,000
b. $295,000
c. $340,000
d. $350,000

1M92#52. The following information pertains to Flint Co.'s sale of 10,000 foreign currency units under a forward contract dated November 1, 1991, for delivery on January 31, 1992:

	11/1/91	*12/31/91*
Spot rates	$0.80	$0.83
30-day future rates	0.79	0.82
90-day future rates	0.78	0.81

Flint entered into the forward contract in order to speculate in the foreign currency. In Flint's income statement for the year ended December 31, 1991, what amount of loss should be reported from this forward contract?

a. $400
b. $300
c. $200
d. $0

1M92#53. Nu Corp. agreed to give Rand Co. a machine in full settlement of a note payable to Rand. The machine's original cost was $140,000. The note's face amount was $110,000. On the date of the agreement:

- The note's carrying amount was $105,000, and its present value was $96,000.
- The machine's carrying amount was $109,000, and its fair value was $96,000.

What amount of gains (losses) should Nu recognize, and how should these be classified in its income statement?

	Extraordinary	*Other*
a.	$(4,000)	$ 0
b.	$ 0	$(4,000)
c.	$ 5,000	$(4,000)
d.	$ 9,000	$(13,000)

1M92#54. Kent Co. incurred the following infrequent losses during 1991:

- A $300,000 loss was incurred on disposal of one of four dissimilar factories.
- A major currency devaluation caused a $120,000 exchange loss on an amount remitted by a foreign customer.
- Inventory valued at $190,000 was made worthless by a competitor's unexpected product innovation.

In its 1991 income statement, what amount should Kent report as losses that are **not** considered extraordinary?

a. $610,000
b. $490,000
c. $420,000
d. $310,000

1M92#55. Ray Finance, Inc. issued a 10-year, $100,000, 9% note on January 1, 1989. The note was issued to yield 10% for proceeds of $93,770. Interest is payable semiannually. The note is callable after two years at a price of $96,000. Due to a decline in the market rate to 8%, Ray retired the note on December 31, 1991. On that date, the carrying amount of the note was $94,582, and the discounted market rate was $105,280. What amount should Ray report as gain (loss) from retirement of the note for the year ended December 31, 1991?

a. $ 9,280
b. $ 4,000
c. $(2,230)
d. $(1,418)

1N91#47. In 1990, Ball Labs incurred the following costs:

Direct costs of doing contract research and development work for the government to be reimbursed by governmental unit	$ 400,000

Research and development costs not included above were:

Depreciation	$300,000
Salaries	700,000
Indirect costs appropriately allocated	200,000
Materials	180,000

What was Ball's total research and development expense in 1990?

a. $1,080,000
b. $1,380,000
c. $1,580,000
d. $1,780,000

1N91
Item 50 is based on the following:

During 1990, Fuqua Steel Co. had the following unusual financial events occur:

- Bonds payable were retired five years before their scheduled maturity, resulting in a $260,000 gain. Fuqua has frequently retired bonds early when interest rates declined significantly.
- A steel forming segment suffered $255,000 in losses due to hurricane damage. This was the fourth similar loss sustained in a 5-year period at that location.
- A segment of Fuqua's operations, steel transportation, was sold at a net loss of $350,000. This was Fuqua's first divestiture of one of its operating segments.

50. Before income taxes, what amount of gain (loss) should be reported separately as a component of income from continuing operations in 1990?

a. $ 260,000
b. $ 5,000
c. $(255,000)
d. $(350,000)

1N91#53. During 1990, Pard Corp. sold goods to its 80%-owned subsidiary, Seed Corp. At December 31, 1990, one-half of these goods were included in Seed's ending inventory. Reported 1990 selling expenses were $1,100,000 and $400,000 for Pard and Seed, respectively. Pard's selling expenses included $50,000 in freight-out costs for goods sold to Seed. What amount of selling expenses should be reported in Pard's 1990 consolidated income statement?

a. $1,500,000
b. $1,480,000
c. $1,475,000
d. $1,450,000

1N91#54. Loeb Corp. frequently borrows from the bank in order to maintain sufficient operating cash. The following loans were at a 12% interest rate, with interest payable at maturity. Loeb repaid each loan on its scheduled maturity date.

Date of loan	*Amount*	*Maturity date*	*Term of loan*
11/1/89	$ 5,000	10/31/90	1 Year
2/1/90	15,000	7/31/90	6 Months
5/1/90	8,000	1/31/91	9 Months

Loeb records interest expense when the loans are repaid. As a result, interest expense of $1,500 was recorded in 1990. If no correction is made, by what amount would 1990 interest expense be understated?

a. $540
b. $620
c. $640
d. $720

1N91#55. On January 1, 1990, Moul Mining Co. (lessee), entered into a 5-year lease for drilling equipment. Moul accounted for the acquisition as a capital lease for $120,000, which includes a $5,000 bargain purchase option. At the end of the lease, Moul expects to exercise the bargain purchase option. Moul estimates that the equipment's fair value will be $10,000 at the end of its 8-year life. Moul regularly uses straight-line depreciation on similar equipment. For the year ended December 31, 1990, what amount should Moul recognize as depreciation expense on the leased asset?

a. $13,750
b. $15,000
c. $23,000
d. $24,000

1N91#57. E & S partnership purchased land for $500,000 on May 1, 1987, paying $100,000 cash and giving a $400,000 note payable to Big State Bank. E & S made three annual payments on the note totaling $179,000, which included interest of $89,000. E & S then defaulted on the note. Title to the land was transferred by E & S to Big State, which cancelled the note, releasing the partnership from further liability. At the time of the default, the fair value of the land approximated the note balance. In E & S's 1990 income statement, the amount of the loss should be

a. $279,000
b. $221,000
c. $190,000
d. $100,000

1M91#51. In connection with a stock option plan for the benefit of key employees, Ward Corp. intends to distribute treasury shares when the options are exercised. These shares were bought in 1989 at $42 per share. On January 1, 1990, Ward granted stock options for 10,000 shares at $38 per share as additional compensation for services to be rendered over the next three years. The options are exercisable during a 4-year period beginning January 1, 1992, by grantees still employed by Ward. Market price of Ward's stock was $47 per share at the grant date. No stock options were terminated during 1990. In Ward's December 31, 1990, income statement, what amount should be reported as compensation expense pertaining to the options?

a. $90,000
b. $40,000
c. $30,000
d. $0

1M91#54. At December 31, 1990, Ashe Co. had a $990,000 balance in its advertising expense account before any year-end adjustments relating to the following:

- Radio advertising spots broadcast during December 1990 were billed to Ashe on January 4, 1991. The invoice cost of $50,000 was paid on January 15, 1991.
- Included in the $990,000 is $60,000 for newspaper advertising for a January 1991 sales promotional campaign.

Ashe's advertising expense for the year ended December 31, 1990, should be

a. $ 930,000
b. $ 980,000
c. $1,000,000
d. $1,040,000

1M91#55. On July 1, 1990, Day Co. received $103,288 for $100,000 face amount, 12% bonds, a price that yields 10%. Interest expense for the six months ended December 31, 1990, should be

a. $6,197
b. $6,000
c. $5,164
d. $5,000

1M91#56. Based on 1990 sales of compact discs recorded by an artist under a contract with Bain Co., the artist earned $100,000 after an adjustment of $8,000 for anticipated returns. In addition, Bain paid the artist $75,000 in 1990 as a reasonable estimate of the amount recoverable from future royalties to be earned by the artist. What amount should Bain report in its 1990 income statement for royalty expense?

a. $100,000
b. $108,000
c. $175,000
d. $183,000

1M91#57. On December 1, 1990, Tell Co. leased office space for five years at a monthly rental of $60,000. On the same date, Tell paid the lessor the following amounts:

First month's rent	$ 60,000
Last month's rent	60,000
Security deposit (refundable at lease expiration)	80,000
Installation of new walls and offices	360,000

Tell's 1990 expense relating to utilization of the office space should be

a. $140,000
b. $120,000
c. $ 66,000
d. $ 60,000

1M91#58. On January 2, 1989, Adam Co. purchased as a long-term investment 10,000 shares of Mill Corp.'s common stock for $40 a share. On December 31, 1989, the market price of Mill's stock was $35 a share, reflecting a temporary decline in market price. On December 28, 1990, Adam sold 8,000 shares of Mill stock for $30 a share. For the year ended December 31, 1990, Adam should report a loss on disposal of long-term investment of

a. $100,000
b. $ 90,000
c. $ 80,000
d. $ 40,000

1N90#40. Brock Corp. reports operating expenses in two categories: (1) selling and (2) general and administrative. The adjusted trial balance at December 31, 1989 included the following expense and loss accounts:

Accounting and legal fees	$120,000
Advertising	150,000
Freight out	80,000
Interest	70,000
Loss on sale of long-term investment	30,000
Officers' salaries	225,000
Rent for office space	220,000
Sales salaries and commissions	140,000

One-half of the rented premises is occupied by the sales department.

Brock's total selling expenses for 1989 are

a. $480,000
b. $400,000
c. $370,000
d. $360,000

1N90#41. On January 1, 1990, Korn Co. sold to Kay Corp. $400,000 of its 10% bonds for $354,118 to yield 12%. Interest is payable semiannually on January 1 and July 1. What amount should Korn report as interest expense for the six months ended June 30, 1990?

a. $17,706
b. $20,000
c. $21,247
d. $24,000

1N90#42. Cody Corp. incurred the following costs during 1989:

Design of tools, jigs, molds, and dies involving new technology	$125,000
Modification of the formulation of a process	160,000
Trouble-shooting in connection with breakdowns during commercial production	100,000
Adaptation of an existing capability to a particular customer's need as part of a continuing commercial activity	110,000

In its 1989 income statement, Cody should report research and development expense of

a. $125,000
b. $160,000
c. $235,000
d. $285,000

1N90#43. Ball Corp. had the following foreign currency transactions during 1989:

- Merchandise was purchased from a foreign supplier on January 20, 1989 for the U.S. dollar equivalent of $90,000. The invoice was paid on March 20, 1989 at the U.S. dollar equivalent of $96,000.
- On July 1, 1989, Ball borrowed the U.S. dollar equivalent of $500,000 evidenced by a note that was payable in the lender's local currency on July 1, 1991. On December 31, 1989, the U.S. dollar equivalents of the principal amount and accrued interest were $520,000 and $26,000, respectively. Interest on the note is 10% per annum.

In Ball's 1989 income statement, what amount should be included as foreign exchange loss?

a. $0
b. $ 6,000
c. $21,000
d. $27,000

1N90#44. On January 1, 1989, Pall Corp. granted stock options to key employees for the purchase of 40,000 shares of the company's common stock at $25 per share. The options are intended to compensate employees for the next two years. The options are exercisable within a four-year period beginning January 1, 1991 by grantees still in the employ of the company. The market price of Pall's common stock was $33 per share at the date of grant. No stock options were terminated during the year. What amount should Pall charge to compensation expense for the year ended December 31, 1989?

a. $320,000
b. $160,000
c. $ 80,000
d. $0

1N90#45. Orr Co. prepared an aging of its accounts receivable at December 31, 1989 and determined that the net realizable value of the receivables was $250,000. Additional information is available as follows:

Allowance for uncollectible accounts at 1/1/89 — credit balance	$28,000
Accounts written off as uncollectible during 1989	23,000
Accounts receivable at 12/31/89	270,000
Uncollectible accounts recovery during 1989	5,000

For the year ended December 31, 1989, Orr's uncollectible accounts expense would be
a. $23,000
b. $20,000
c. $15,000
d. $10,000

1N90#46. Kew Apparel, Inc. leases and operates a retail store. The following information relates to the lease for the year ended December 31, 1989:

- The store lease, an operating lease, calls for a base monthly rent of $1,500 on the first day of each month.
- Additional rent is computed at 6% of net sales over $300,000 up to $600,000 and 5% of net sales over $600,000, per calendar year.
- Net sales for 1989 were $900,000.
- Kew paid executory costs to the lessor for property taxes of $12,000 and insurance of $5,000.

For 1989, Kew's expenses relating to the store lease are
a. $71,000
b. $68,000
c. $54,000
d. $35,000

1N90#47. Strand, Inc. incurred the following infrequent losses during 1989:

- A $90,000 write-down of equipment leased to others.
- $50,000 adjustment of accruals on long-term contracts.
- A $75,000 write-off of obsolete inventory.

In its 1989 income statement, what amount should Strand report as total infrequent losses that are **not** considered extraordinary?
a. $215,000
b. $165,000
c. $140,000
d. $125,000

2N90#8. The following information was derived from the 1989 accounting records of Clem Co.:

	Clem's central warehouse	*Clem's goods held by consignees*
Beginning inventory	$110,000	$12,000
Purchases	480,000	60,000
Freight in	10,000	
Transportation to consignees		5,000
Freight out	30,000	8,000
Ending inventory	145,000	20,000

Clem's 1989 cost of sales was
a. $455,000
b. $485,000
c. $507,000
d. $512,000

2N90#10. The following items were among those that were reported on Lee Co.'s income statement for the year ended December 31, 1989:

Legal and audit fees	$170,000
Rent for office space	240,000
Interest on inventory floorplan	210,000
Loss on abandoned data processing equipment used in operations	35,000

The office space is used equally by Lee's sales and accounting departments. What amount of the above-listed items should be classified as general and administrative expenses in Lee's multiple-step income statement?
a. $290,000
b. $325,000
c. $410,000
d. $500,000

2N90#11. On its December 31, 1988 balance sheet, Nilo Corp. reported bonds payable of $8,000,000 and related unamortized bond issue costs of $430,000. The bonds had been issued at par. On January 2, 1989, Nilo retired $4,000,000 of the outstanding bonds at par plus a call premium of $100,000. What amount should Nilo report in its 1989 income statement as loss on extinguishment of debt?
a. $0
b. $100,000
c. $215,000
d. $315,000

2N90#12. Zahn Corp.'s comparative balance sheet at December 31, 1989 and 1988 reported accumulated depreciation balances of $800,000 and $600,000 respectively. Property with a cost of $50,000 and a carrying amount of $40,000 was the only property sold in 1989. Depreciation charged to operations in 1989 was
a. $190,000
b. $200,000
c. $210,000
d. $220,000

1M90#49. The following information was taken from Cody Co.'s accounting records for the year ended December 31, 1989:

Decrease in raw materials inventory	$ 15,000
Increase in finished goods inventory	35,000
Raw materials purchased	430,000
Direct labor payroll	200,000
Factory overhead	300,000
Freight-out	45,000

There was no work-in-process inventory at the beginning or end of the year. Cody's 1989 cost of goods sold is

a. $895,000
b. $910,000
c. $950,000
d. $955,000

1M90
Items 50 and 51 are based on the following:

On January 2, 1989, Dix Machine Shops, Inc. signed a ten-year noncancellable lease for a heavy duty drill press. The lease stipulated annual payments of $30,000 starting at the end of the first year, with title passing to Dix at the expiration of the lease. Dix treated this transaction as a capital lease. The drill press has an estimated useful life of 15 years, with no salvage value. Dix uses straight-line depreciation for all of its fixed assets. Aggregate lease payments were determined to have a present value of $180,000, based on implicit interest of 10%.

50. In its 1989 income statement, what amount of interest expense should Dix report from this lease transaction?

a. $0
b. $12,000
c. $15,000
d. $18,000

51. In its 1989 income statement, what amount of depreciation expense should Dix report from this lease transaction?

a. $30,000
b. $20,000
c. $18,000
d. $12,000

1M90#52. Fay Corp. had a realized foreign exchange loss of $15,000 for the year ended December 31, 1989 and must also determine whether the following items will require year-end adjustment:

- Fay had an $8,000 loss resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1989.
- Fay had an account payable to an unrelated foreign supplier payable in the supplier's local currency. The U.S. dollar equivalent of the payable was $64,000 on the October 31, 1989 invoice date, and it was $60,000 on December 31, 1989. The invoice is payable on January 30, 1990.

In Fay's 1989 consolidated income statement, what amount should be included as foreign exchange loss?

a. $11,000
b. $15,000
c. $19,000
d. $23,000

1M90#53. During 1989, Vest Co. incurred the following costs:

Testing in search for process alternatives	$280,000
Routine design of tools, jigs, molds and dies	250,000
Modification of the formulation of a process	410,000
Research and development services performed by Acme Corp. for Vest	325,000

In Vest's 1989 income statement, research and development expense should be

a. $ 410,000
b. $ 735,000
c. $1,015,000
d. $1,265,000

1M90#54. For the year ended December 31, 1989, Beal Co. estimated its allowance for uncollectible accounts using the year-end aging of accounts receivable. The following data are available:

Allowance for uncollectible accounts, 1/1/89	$42,000
Provision for uncollectible accounts during 1989 (2% on credit sales of $2,000,000)	40,000
Uncollectible accounts written off, 11/30/89	46,000
Estimated uncollectible accounts per aging, 12/31/89	52,000

After year-end adjustment, the uncollectible accounts expense for 1989 should be

a. $46,000
b. $48,000
c. $52,000
d. $56,000

1M90#55. On January 2, 1989, Morey Corp. granted Dean, its president, 20,000 stock appreciation rights for past services. Those rights are exercisable immediately and expire on January 1, 1992. On exercise, Dean is entitled to receive cash for the excess of the stock's market price on the exercise date over the market price on the grant date. Dean did not exercise any of the rights during 1989. The market price of Morey's stock was $30 on January 2, 1989 and $45 on December 31, 1989. As a result of the stock appreciation rights, Morey should recognize compensation expense for 1989 of

a. $0
b. $100,000
c. $300,000
d. $600,000

1M90#56. On January 1, 1989, Park Co. signed a 10-year operating lease for office space at $96,000 per year. The lease included a provision for additional rent of 5% of annual company sales in excess of $500,000. Park's sales for the year ended December 31, 1989 were $600,000. Upon execution of the lease, Park paid $24,000 as a bonus for the lease. Park's rent expense for the year ended December 31, 1989 is

a. $ 98,400
b. $101,000
c. $103,400
d. $125,000

1M90#57. During 1988, Wall Co. purchased 2,000 shares of Hemp Corp. common stock for $31,500 as a short-term investment. The market value of this investment was $29,500 at December 31, 1988. Wall sold all of the Hemp common stock for $14 per share on December 15, 1989, incurring $1,400 in brokerage commissions and taxes. On the sale, Wall should report a realized loss of

a. $4,900
b. $3,500
c. $2,900
d. $1,500

1M90#58. Witt Co. incurred the following infrequent losses during 1989:

- $175,000 from a major strike by employees.
- $150,000 from an early extinguishment of debt.
- $125,000 from the abandonment of equipment used in the business.

In Witt's 1989 income statement, the total amount of infrequent losses **not** considered extraordinary should be

a. $275,000
b. $300,000
c. $325,000
d. $450,000

2M90#42. Bird Corp.'s trademark was licensed to Brian Co. for royalties of 15% of sales of the trademarked items. Royalties are payable semiannually on March 15 for sales in July through December of the prior year, and on September 15 for sales in January through June of the same year. Bird received the following royalties from Brian:

	March 15	*September 15*
1988	$5,000	$7,500
1989	6,000	8,500

Brian estimated that sales of the trademarked items would total $30,000 for July through December 1989.

In Bird's 1989 income statement, the royalty revenue should be

a. $13,000
b. $14,500
c. $19,000
d. $20,500

2M90#46. Doren Co.'s officers' compensation expense account had a balance of $490,000 at December 31, 1989 before any appropriate year-end adjustment relating to the following:

- No salary accrual was made for the week of December 25–31, 1989. Officers' salaries for this period totaled $18,000 and were paid on January 5, 1990.
- Bonuses to officers for 1989 were paid on January 31, 1990 in the total amount of $175,000.

The adjusted balance for officers' compensation expense for the year ended December 31, 1989 should be

a. $683,000
b. $665,000
c. $508,000
d. $490,000

2M90#48. Casey Co.'s adjusted trial balance at December 31, 1989 included the following expense accounts:

Advertising	$250,000
Freight-out	75,000
Rent for office space	180,000
Sales salaries and commissions	200,000

One-half of the office space is occupied by the sales department.

What total amount of the expenses listed above should be included in Casey's selling and delivery expenses for 1989?

a. $450,000
b. $525,000
c. $540,000
d. $615,000

2M90#49. On January 1, 1988, Layton Co. acquired the copyright to a book owned by Garner for royalties of 15% of future book sales. Royalties are payable on September 30 for sales in January through June of the same year, and on March 31 for sales in July through December of the preceding year. During 1988 and 1989, Layton remitted royalty checks to Garner as follows:

	March 31	*September 30*
1988	$ —	$25,000
1989	22,000	40,000

Layton's sales of the Garner book totaled $300,000 for the last half of 1989. In its 1989 income statement, Layton should report royalty expense of

a. $85,000
b. $67,000
c. $62,000
d. $45,000

1N89#42. On December 1, 1988, Barr Company leased office space for five years at a monthly rental of

$60,000. On that date, Barr paid the lessor the following amounts:

First month's rent	$ 60,000
Last month's rent	60,000
Security deposit (refundable at lease expiration)	80,000
Installation of new walls and offices	360,000

Barr's December 1988 expense relating to its use of this office space is
a. $ 60,000
b. $ 66,000
c. $126,000
d. $200,000

1N89#45. The following data were available from Mith Co.'s records on December 31, 1988:

Finished goods inventory, 1/1/88	$120,000
Finished goods inventory, 12/31/88	110,000
Cost of goods manufactured	520,000
Loss on sale of plant equipment	50,000

The cost of goods sold for 1988 was
a. $510,000
b. $520,000
c. $530,000
d. $580,000

1M89#12. As an inducement to enter a lease, Arts, Inc., a lessor, grants Hompson Corp., a lessee, nine months of free rent under a five-year operating lease. The lease is effective on July 1, 1988 and provides for monthly rental of $1,000 to begin April 1, 1989.

In Hompson's income statement for the year ended June 30, 1989, rent expense should be reported as
a. $10,200
b. $ 9,000
c. $ 3,000
d. $ 2,550

1M89#19. During 1988, Rine Company incurred the following costs:

Research and development services performed by Lee Corp. for Rine	$300,000
Testing for evaluation of new products	250,000
Laboratory research aimed at discovery of new knowledge	370,000
Routine design of tools, jigs, molds, and dies	100,000

In its income statement for the year ended December 31, 1988, Rine should report research and development expense of
a. $1,020,000
b. $ 920,000
c. $ 720,000
d. $ 670,000

1M89#20. The balance in Bart Corp.'s foreign exchange loss account was $13,000 at December 31, 1988, before any necessary year-end adjustment relating to the following:

- Bart had a $20,000 loss resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1988.
- Bart had an account payable to an unrelated foreign supplier payable in the local currency of the foreign supplier on January 27, 1989. The U.S. dollar equivalent of the payable was $100,000 on the November 28, 1988 invoice date, and it was $106,000 on December 31, 1988.

In Bart's 1988 consolidated income statement, what amount should be included as foreign exchange loss?
a. $33,000
b. $27,000
c. $19,000
d. $13,000

1M89#48. Cain Co. issued $400,000 face amount of its 10% bonds on January 1, 1989 for $354,118 to yield the buyer a 12% effective rate of return. Interest is payable semiannually on January 1 and July 1. What amount would Cain report as interest expense in its June 30, 1989 income statement?
a. $18,753
b. $20,000
c. $21,247
d. $24,000

1N88#43. The following information is available for Mason Corp. for 1987:

Sales	$100,000
Beginning inventory	36,000
Ending inventory	19,000
Freight out	9,000
Purchases	43,000

Mason's cost of goods sold for 1987 is
a. $52,000
b. $60,000
c. $69,000
d. $88,000

1M88#48. The following information is available from Dell Company's 1987 accounting records:

Purchases	$530,000
Purchase discounts	10,000
Beginning inventory	160,000
Ending inventory	215,000
Freight-out	40,000

Dell's 1987 cost of goods sold is
a. $465,000
b. $475,000
c. $505,000
d. $585,000

1M88#51. Wren Company had the following account balances at December 31, 1987:

Accounts receivable	$ 900,000
Allowance for doubtful accounts (before any provision for 1987 doubtful accounts expense)	16,000
Credit sales for 1987	1,750,000

Wren is considering the following methods of estimating doubtful accounts expense for 1987:

- Based on credit sales at 2%
- Based on accounts receivable at 5%

What amount should Wren charge to doubtful accounts expense under each method?

	Percentage of credit sales	*Percentage of accounts receivable*
a.	$51,000	$45,000
b.	$51,000	$29,000
c.	$35,000	$45,000
d.	$35,000	$29,000

1M88#52. On October 1, 1987, Dean Company leased office space at a monthly rental of $30,000 for 10 years expiring September 30, 1997. As an inducement for Dean to enter into the lease, the lessor permitted Dean to occupy the premises rent-free from October 1 to December 31, 1987. For the year ended December 31, 1987, Dean should record rent expense of

a. $0
b. $29,250
c. $87,750
d. $90,000

C. Provision for Income Tax

In February 1992, the FASB issued Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes,* superceding Statement of Financial Accounting Standards No. 96, *Accounting for Income Taxes.* Accordingly, future examinations will test knowledge of SFAS No. 109.

1M92#56. Busy Corp. prepared the following reconciliation between pretax accounting income and taxable income for the year ended December 31, 1991:

Pretax accounting income	$250,000
Taxable income	150,000
Difference	$100,000
Analysis of difference:	
Interest on municipal bonds	$ 25,000
Excess of tax over book depreciation	75,000
	$100,000

Busy uses FASB Statement No. 96, *Accounting for Income Taxes.* Busy's effective income tax rate for 1991 is 30%. The depreciation difference will reverse in equal amounts over the next three years at an enacted tax rate of 40%.

In Busy's 1991 income statement, what amount should be reported as the current portion of its provision for income taxes?

a. $45,000
b. $67,500
c. $75,000
d. $82,500

1N91#48. Leer Corp.'s pretax income in 1990 was $100,000. The temporary differences between amounts reported in the financial statements and the tax return are as follows:

- Depreciation in the financial statements was $8,000 more than tax depreciation.

- The equity method of accounting resulted in financial statement income of $35,000. A $25,000 dividend was received during the year, which is eligible for the 80% dividends received deduction.

Leer's effective income tax rate was 30% in 1990. In its 1990 income statement, Leer should report a current provision for income taxes of

a. $26,400
b. $23,400
c. $21,900
d. $18,600

1N91#59. Shear, Inc. began operations in 1990. Included in Shear's 1990 financial statements were bad debt expenses of $1,400 and profit from an installment sale of $2,600. For tax purposes, the bad debts will be deducted and the profit from the installment sale will be recognized in 1992. The enacted tax rates are 30% in 1990 and 25% in 1992. Shear elected early application of FASB Statement No. 96, *Accounting for Income Taxes.* In its 1990 income statement, what amount should Shear report as deferred income tax expense?

a. $300
b. $360
c. $650
d. $780

1N90#48. For calendar year 1989, Clark Corp. reported depreciation of $300,000 in its income statement. On its 1989 income tax return, Clark reported depreciation of $500,000. Clark's income statement also included $50,000 accrued warranty expense that will be deducted for tax purposes when paid. Clark elected early application of FASB Statement No. 96, *Accounting for Income Taxes,* in its financial statements for the year ended December 31, 1989. Clark's enacted tax rates are 30% for 1989 and 1990, and 25% for 1991 and 1992. The depreciation difference and warranty expense will reverse over the next three years as follows:

	Depreciation difference	*Warranty expense*
1990	$ 80,000	$10,000
1991	70,000	15,000
1992	50,000	25,000
	$200,000	$50,000

These were Clark's only temporary differences. In Clark's 1989 income statement, the deferred portion of its provision for income taxes should be

a. $67,000
b. $45,000
c. $41,000
d. $37,500

2N90#7. Ram Corp. prepared the following reconciliation of income per books with income per tax return for the year ended December 31, 1989:

Book income before income taxes	$750,000
Add temporary difference	
Construction contract revenue which will reverse in 1993	100,000
Deduct temporary difference	
Depreciation expense which will reverse in equal amounts in each of the next four years	(400,000)
Taxable income	$450,000

Ram's effective income tax rate is 34% for 1989. What amount should Ram report in its 1989 income statement as the current provision for income taxes?

a. $ 34,000
b. $153,000
c. $255,000
d. $289,000

1M90#39. For the year ended March 31, 1990, Dunn Corp.'s pretax financial statement income was $700,000, and its taxable income was $600,000. The difference is due to the following:

Interest on municipal bonds	$ 30,000
Lower depreciation for financial statement	70,000
Total	$100,000

Dunn elected early application of FASB Statement No. 96, *Accounting for Income Taxes*. Dunn's enacted income tax rate is 30%. What is Dunn's current portion of income tax expense for the year ended March 31, 1990?

a. $210,000
b. $189,000
c. $180,000
d. $159,000

1M90#41. In 1989, Lobo Corp. reported for financial statement purposes the following revenue and expenses which were not included in taxable income:

Premiums on officers' life insurance under which the corporation is the beneficiary	$ 5,000
Interest revenue on qualified state or municipal bonds	10,000
Estimated future warranty costs to be paid in 1990 and 1991	60,000

Lobo's enacted tax rate for the current and future years is 30%. Lobo has paid income taxes in the amount of $170,000 for the three-year period ended December 31, 1989. There were no temporary differences in prior years.

Lobo elected early application of FASB Statement No. 96, *Accounting for Income Taxes*. The deferred tax benefit to be applied against current income tax expense is

a. $18,000
b. $19,500
c. $21,000
d. $22,500

D. Recurring Versus Nonrecurring Transactions and Events

1M92#57. On December 31, 1990, Greer Co. entered into an agreement to sell its Hart segment's assets. On that date, Greer estimated the gain from the disposition of the assets in 1991 would be $700,000 and Hart's 1991 operating losses would be $200,000. Hart's actual operating losses were $300,000 in both 1990 and 1991, and the actual gain on disposition of Hart's assets in 1991 was $650,000. Disregarding income taxes, what net gain (loss) should be reported for discontinued operations in Greer's comparative 1991 and 1990 income statements?

	1991	*1990*
a.	$ 50,000	$(300,000)
b.	$ 0	$ 50,000
c.	$ 350,000	$(300,000)
d.	$(150,000)	$ 200,000

1M92#58. On December 31, 1991, Wright Corp. placed cash of $875,000 in an irrevocable trust that meets the necessary defeasance requirements. The trust's assets are to be used solely for satisfying obligations on Wright's 6%, $1,100,000, 30-year bond payable. Wright has not been legally released from its obligations under the bond agreement, but any additional liability is considered remote. On December 31, 1991, the bond's carrying amount was $1,050,000, and its present value was $800,000. Disregarding income taxes, what amount of extraordinary gain (loss) should Wright report in its 1991 income statement?

a. $(75,000)
b. $175,000
c. $225,000
d. $250,000

1N91#45. Munn Corp.'s income statements for the years ended December 31, 1990 and 1989, included the following, before adjustments:

	1990	*1989*
Operating income	$ 800,000	$600,000
Gain on sale of division	450,000	—
	1,250,000	600,000
Provision for income taxes	375,000	180,000
Net income	$ 875,000	$420,000

On January 1, 1990, Munn agreed to sell the assets and product line of one of its operating divisions for $1,600,000. The sale was consummated on December 31, 1990, and resulted in a gain on disposition of $450,000. This division's net losses were $320,000 in 1990 and $250,000 in 1989. The income tax rate for both years was 30%. In preparing revised comparative income statements, Munn should report which of the following amounts of gain (loss) from discontinued operations

	1990	*1989*
a.	$130,000	$0
b.	$130,000	$(250,000)
c.	$ 91,000	$0
d.	$ 91,000	$(175,000)

1N91
Item 51 is based on the following:

During 1990, Fuqua Steel Co. had the following unusual financial events occur:

- Bonds payable were retired five years before their scheduled maturity, resulting in a $260,000 gain. Fuqua has frequently retired bonds early when interest rates declined significantly.
- A steel forming segment suffered $255,000 in losses due to hurricane damage. This was the fourth similar loss sustained in a 5-year period at that location.
- A segment of Fuqua's operations, steel transportation, was sold at a net loss of $350,000. This was Fuqua's first divestiture of one of its operating segments.

51. Before income taxes, what amount should be disclosed as the gain (loss) from extraordinary items in 1990?
   a. $ 260,000
   b. $ 5,000
   c. $(90,000)
   d. $(350,000)

1N90#49. On May 15, 1989, Munn, Inc. approved a plan to dispose of a segment of its business. It is expected that the sale will occur on February 1, 1990 at a selling price of $500,000. During 1989, disposal costs incurred by Munn totaled $75,000. The segment had actual or estimated operating losses as follows:

1/ 1/89 to 5/14/89	$130,000
5/15/89 to 12/31/89	50,000
1/ 1/90 to 1/31/90	15,000

The carrying amount of the segment at the date of sale was expected to be $850,000. Before income taxes, what amount should Munn report as a loss on disposal of the segment in its 1989 income statement?
   a. $490,000
   b. $475,000
   c. $440,000
   d. $425,000

1N90#50. On January 1, 1990, Hart, Inc. redeemed its 15-year bonds of $500,000 par value for 102. They were originally issued on January 1, 1978 at 98 with a maturity date of January 1, 1993. The bond issue costs relating to this transaction were $20,000. Hart amortizes discounts, premiums, and bond issue costs using the straight-line method. What amount of extraordinary loss should Hart recognize on the redemption of these bonds?
   a. $16,000
   b. $12,000
   c. $10,000
   d. $0

2M90#47. On April 30, 1989, Carty Corp. approved a plan to dispose of a segment of its business. The estimated disposal loss is $480,000, including severance pay of $55,000 and employee relocation costs of $25,000, both of which are directly associated with the decision to dispose of the segment. Also included is the segment's estimated operating loss of $100,000 for the period from May 1, 1989 to the disposal date. A $120,000 operating loss from January 1, 1989 to April 30, 1989 is **not** included in the estimated disposal loss of $480,000. Before income taxes, what amount should be reported in Carty's income statement for the year ended December 31, 1989 as the loss from discontinued operations?
   a. $600,000
   b. $480,000
   c. $455,000
   d. $425,000

1N89#46. On January 1, 1988, Dart, Inc. entered into an agreement to sell the assets and product line of its Jay Division, considered a segment of the business. The sale was consummated on December 31, 1988 and resulted in a gain on disposition of $400,000. The division's operations resulted in losses before income tax of $225,000 in 1988 and $125,000 in 1987. Dart's income tax rate is 30% for both years. In a comparative statement of income for 1988 and 1987, as components under the caption Discontinued Operations, Dart should report a gain (loss) amounting to

	1988	*1987*
a.	$122,500	($87,500)
b.	$122,500	$0
c.	($157,500)	($87,500)
d.	($157,500)	$0

1N89#50. Lowe Corp. had the following gains, net of applicable taxes, during 1988:

Foreign currency transaction gain due to major devaluation	$175,000
Gain from early extinguishment of Lowe's debt	250,000

What amount should Lowe report as extraordinary gains in its 1988 income statement?
a. $425,000
b. $250,000
c. $175,000
d. $0

1M89#60. On April 30, 1988, Wall Corp. approved a plan to dispose of a segment of its business. For the period January 1 through April 30, 1988, the segment had revenues of $600,000 and expenses of $750,000. The assets of the segment were sold on October 15, 1988 at a loss, from which no tax benefit is available. In its income statement for the year ended December 31, 1988, how should Wall report the segment's operations from January 1 to April 30, 1988?
a. $600,000 and $750,000 should be included with revenues and expenses, respectively, as part of continuing operations.
b. $150,000 should be reported as part of the loss on disposal of a segment.
c. $150,000 should be reported as an extraordinary loss.
d. $150,000 should be reported as a loss from operations of a discontinued segment.

1N88#45. On October 1, 1987, Burns Corp. approved a formal plan to sell Hall division, a business segment. The sale was scheduled to take place on March 31, 1988. Hall had operating income of $100,000 for the quarter ended December 31, 1987, and expected to incur an operating loss of $50,000 for the first quarter of 1988. Burns estimated that it would incur a $375,000 loss on the sale of Hall's assets. Burns' income tax rate for 1987 was 30%. In its 1987 income statement, Burns should report a loss on the disposal of Hall division of
a. $325,000
b. $297,500
c. $262,500
d. $227,500

1N88#47. Burl Company incurred the following loss and realized the following gain during 1987:

- $50,000 loss as the result of an unanticipated strike by its employees.
- $25,000 gain as the result of the early extinguishment of bonds payable.

Burl's income tax rate for 1987 was 30%. Burl's 1987 income statement should report an extraordinary loss and an extraordinary gain of

	Extraordinary loss	*Extraordinary gain*
a.	$0	$0
b.	$0	$17,500
c.	$35,000	$0
d.	$35,000	$17,500

E. Accounting Changes

1N91#56. Goddard has used the FIFO method of inventory valuation since it began operations in 1987. Goddard decided to change to the weighted-average method for determining inventory costs at the beginning of 1990. The following schedule shows year-end inventory balances under the FIFO and weighted-average methods:

Year	*FIFO*	*Weighted-average*
1987	$45,000	$54,000
1988	78,000	71,000
1989	83,000	78,000

What amount, before income taxes, should be reported in the 1990 income statement as the cumulative effect of the change in accounting principle?
a. $5,000 decrease.
b. $3,000 decrease.
c. $2,000 increase.
d. $0.

1M91#59. On December 31, 1990, Rapp Co. changed inventory cost methods to FIFO from LIFO for financial statement and income tax purposes. The change will result in a $175,000 increase in the beginning inventory at January 1, 1990. Assuming a 30% income tax rate, the cumulative effect of this accounting change reported in the income statement for the year ended December 31, 1990, is
a. $175,000
b. $122,500
c. $ 52,500
d. $0

1M91#60. On January 1, 1985, Pell Corp. purchased a machine having an estimated useful life of 10 years and no salvage. The machine was depreciated by the double declining balance method for both financial statement and income tax reporting. On January 1, 1990, Pell changed to the straight-line method for financial statement reporting but not for income tax reporting. Accumulated depreciation at December 31, 1989, was $560,000. If the straight-line method had been used, the accumulated depreciation at December 31, 1989, would have been $420,000. Pell's enacted income tax rate for 1990 and thereafter is 30%. The amount shown in the 1990 income statement for the cumulative effect of changing to the straight-line method should be

a. $ 98,000 debit.
b. $ 98,000 credit.
c. $140,000 credit.
d. $140,000 debit.

1N90#51. On January 1, 1986, Flax Co. purchased a machine for $528,000 and depreciated it by the straight-line method using an estimated useful life of eight years with no salvage value. On January 1, 1989, Flax determined that the machine had a useful life of six years from the date of acquisition and will have a salvage value of $48,000. An accounting change was made in 1989 to reflect these additional data. The accumulated depreciation for this machine should have a balance at December 31, 1989 of

a. $292,000
b. $308,000
c. $320,000
d. $352,000

1N89#51. On December 31, 1988, Kerr, Inc. appropriately changed its inventory valuation method to FIFO cost from weighted-average cost for financial statement and income tax purposes. The change will result in a $700,000 increase in the beginning inventory at January 1, 1988. Assume a 30% income tax rate. The cumulative effect of this accounting change reported for the year ended December 31, 1988 is

a. $0
b. $210,000
c. $490,000
d. $700,000

1N89#52. On January 1, 1987, Aker Corp. acquired a machine at a cost of $200,000. It was to be depreciated on the straight line method over a five-year period with no residual value. Because of a bookkeeping error, no depreciation was recognized in Aker's 1987 financial statements. The oversight was discovered during the preparation of Aker's 1988 financial statements. Depreciation expense on this machine for 1988 should be

a. $0
b. $40,000
c. $50,000
d. $80,000

1M89#52. On January 1, 1988, Roem Corp. changed its inventory method to FIFO from LIFO for both financial and income tax reporting purposes. The change resulted in a $500,000 increase in the January 1, 1988 inventory. Assume that the income tax rate for all years is 30%. The cumulative effect of the accounting change should be reported by Roem in its 1988

a. Retained earnings statement as a $350,000 addition to the beginning balance.
b. Income statement as a $350,000 cumulative effect of accounting change.
c. Retained earnings statement as a $500,000 addition to the beginning balance.
d. Income statement as a $500,000 cumulative effect of accounting change.

F. Earnings Per Share

1M92#59. Timp, Inc. had the following common stock balances and transactions during 1991:

1/1/91	Common stock outstanding	30,000
2/1/91	Issued a 10% common stock dividend	3,000
3/1/91	Issued common stock in a pooling of interests	9,000
7/1/91	Issued common stock for cash	8,000
12/31/91	Common stock outstanding	50,000

What was Timp's 1991 weighted average shares outstanding?

a. 40,000
b. 44,250
c. 44,500
d. 46,000

1M92#60. On June 30, 1990, Lomond, Inc. issued twenty $10,000, 7% bonds at par. Each bond was convertible into 200 shares of common stock. On January 1, 1991, 10,000 shares of common stock were outstanding. The bondholders converted all the bonds on July 1, 1991. On the bonds' issuance date, the average Aa corporate bond yield was 12%. During 1991, the average Aa corporate bond yield was 9%. The following amounts were reported in Lomond's income statement for the year ended December 31, 1991:

Revenues	$977,000
Operating expenses	920,000
Interest on bonds	7,000
Income before income tax	50,000
Income tax at 30%	15,000
Net income	$ 35,000

What amount should Lomond report as its 1991 primary earnings per share?

a. $2.50
b. $2.85
c. $2.92
d. $3.50

1N91#60. Strauch Co. has one class of common stock outstanding and no other securities that are potentially convertible into common stock. During 1989, 100,000 shares of common stock were outstanding. In 1990, two distributions of additional common shares occurred: On April 1, 20,000 shares of treasury stock were sold, and on July 1, a 2-for-1 stock split was issued. Net income was $410,000 in 1990 and $350,000 in 1989. What amounts should Strauch report as earnings per share in its 1990 and 1989 comparative income statements?

	1990	*1989*
a.	$1.78	$3.50
b.	$1.78	$1.75
c.	$2.34	$1.75
d.	$2.34	$3.50

1N90#52. Poe Co. had 300,000 shares of common stock issued and outstanding at December 31, 1988. No common stock was issued during 1989. On January 1, 1989, Poe issued 200,000 shares of nonconvertible preferred stock. During 1989, Poe declared and paid $75,000 cash dividends on the common stock and $60,000 on the preferred stock. Net income for the year ended December 31, 1989 was $330,000. What should be Poe's 1989 earnings per common share?

a. $1.10
b. $0.90
c. $0.85
d. $0.65

2M90#51. Peters Corp.'s capital structure was as follows:

	December 31	
	1988	*1989*
Outstanding shares of stock:		
Common	110,000	110,000
Convertible preferred	10,000	10,000
8% convertible bonds	$1,000,000	$1,000,000

During 1989, Peters paid dividends of $3.00 per share on its preferred stock. The preferred shares are convertible into 20,000 shares of common stock and are considered common stock equivalents. The 8% bonds are convertible into 30,000 shares of common stock but are not considered common stock equivalents. Net income for 1989 was $850,000. Assume that the income tax rate is 30%. The primary earnings per share for 1989 is

a. $6.31
b. $6.54
c. $7.08
d. $7.45

1N89#54. Jones Corp.'s capital structure was as follows:

	December 31	
	1988	*1987*
Outstanding shares of stock:		
Common	110,000	110,000
Convertible preferred	10,000	10,000
8% convertible bonds	$1,000,000	$1,000,000

During 1988, Jones paid dividends of $3.00 per share on its preferred stock. The preferred shares are convertible into 20,000 shares of common stock and are considered common stock equivalents. The 8% bonds are convertible into 30,000 shares of common stock but are not considered common stock equivalents. Net income for 1988 is $850,000. Assume that the income tax rate is 30%.

The fully diluted earnings per share for 1988 is

a. $5.48
b. $5.66
c. $5.81
d. $6.26

1N88#50. During 1987, Moore Corp. had the following two classes of stock issued and outstanding for the entire year:

- 100,000 shares of common stock, $1 par.
- 1,000 shares of 4% preferred stock, $100 par, convertible share for share into common stock. This stock is not a common stock equivalent.

Moore's 1987 net income was $900,000, and its income tax rate for the year was 30%. In the computation of primary earnings per share for 1987, the amount to be used in the numerator is

a. $896,000
b. $898,800
c. $900,000
d. $901,200

1N88#57. On January 1, 1987, Apex Company, whose stock is publicly traded, had 100,000 shares of common stock issued and outstanding. On April 1, 1987, Apex issued a 10% stock dividend. The number of shares to be used in the computation of earnings per share for 1987 is

a. 100,000
b. 105,000
c. 107,500
d. 110,000

VI. Other Financial Topics

A. Disclosures in Notes to the Financial Statements

2N91#13. Kell Corp.'s $95,000 net income for the quarter ended September 30, 1990, included the following after-tax items:

- A $60,000 extraordinary gain, realized on April 30, 1990, was allocated equally to the second, third, and fourth quarters of 1990.

- A $16,000 cumulative-effect loss resulting from a change in inventory valuation method was recognized on August 2, 1990.

In addition, Kell paid $48,000 on February 1, 1990, for *1990* calendar-year property taxes. Of this amount, $12,000 was allocated to the third quarter of 1990.

For the quarter ended September 30, 1990, Kell should report net income of

a. $ 91,000
b. $103,000
c. $111,000
d. $115,000

1N90#53. Dean Co. acquired 100% of Morey Corp. prior to 1989. During 1989, the individual companies included in their financial statements the following:

	Dean	*Morey*
Officers' salaries	$ 75,000	$ 50,000
Officers' expenses	20,000	10,000
Loans to officers	125,000	50,000
Intercompany sales	150,000	—

What amount should be reported as related party disclosures in the notes to Dean's 1989 consolidated financial statements?

a. $150,000
b. $155,000
c. $175,000
d. $330,000

1N90#54. Witt Corp. has outstanding at December 31, 1989 two long-term borrowings with annual sinking fund requirements and maturities as follows:

	Sinking fund requirements	*Maturities*
1989	$1,000,000	$ —
1990	1,500,000	2,000,000
1991	1,500,000	2,000,000
1992	2,000,000	2,500,000
1993	2,000,000	3,000,000
	$8,000,000	$9,500,000

In the notes to its December 31, 1989 balance sheet, how should Witt report the above data?

a. No disclosure is required.
b. Only sinking fund payments totaling $8,000,000 for the next five years detailed by year need be disclosed.
c. Only maturities totaling $9,500,000 for the next five years detailed by year need be disclosed.
d. The combined aggregate of $17,500,000 of maturities and sinking fund requirements detailed by year should be disclosed.

1N89#53. On January 1, 1987, West Co. entered into a ten-year lease for a manufacturing plant. The annual minimum lease payments are $100,000. In the notes to the December 31, 1988 financial statements, what amounts of subsequent years' lease payments should be disclosed?

	Amount for appropriate required period	*Aggregate amount for the period thereafter*
a.	$100,000	$0
b.	$300,000	$500,000
c.	$500,000	$300,000
d.	$500,000	$0

2M89#16. In March 1988, an explosion occurred at Nilo Co.'s plant, causing damage to area properties. By May 1988, no claims had yet been asserted against Nilo. However, Nilo's management and legal counsel concluded that it was reasonably possible that Nilo would be held responsible for negligence, and that $3,000,000 would be a reasonable estimate of the damages. Nilo's $5,000,000 comprehensive public liability policy contains a $300,000 deductible clause. In Nilo's December 31, 1987 financial statements, for which the auditor's fieldwork was completed in April 1988, how should this casualty be reported?

a. As a footnote disclosing a possible liability of $3,000,000.
b. As an accrued liability of $300,000.
c. As a footnote disclosing a possible liability of $300,000.
d. No footnote disclosure or accrual is required for 1987 because the event occurred in 1988.

1N88#51. During 1987, Jones Company engaged in the following transactions:

• Salary expense to key employees who are also principal owners	$100,000
• Sales to affiliated enterprises	250,000

Which of the two transactions would be disclosed as related party transactions in Jones's 1987 financial statements?
a. Neither transaction.
b. The $100,000 transaction only.
c. The $250,000 transaction only.
d. Both transactions.

1M88#46. A personal injury liability suit for $500,000 was brought against Ashe Corp. during 1987. Ashe's management and counsel concluded that it is reasonably possible that Ashe will be responsible for damages, and that $150,000 is a reasonable estimate of the damages. In Ashe's December 31, 1987 financial statements, how should this item be reported?
a. No disclosure in the financial statements or accrual is required.
b. As an accrued liability of $50,000 and as a disclosure in the financial statements indicating the exposure to an additional amount of loss up to $350,000.
c. As an accrued liability of $150,000 only.
d. As a disclosure only in the financial statements indicating the possible loss of $150,000.

C. Nonmonetary Transactions

2M92#11. Yola Co. and Zaro Co. are fuel oil distributors. To facilitate the delivery of oil to their customers, Yola and Zaro exchanged ownership of 1,200 barrels of oil without physically moving the oil. Yola paid Zaro $30,000 to compensate for a difference in the grade of oil. On the date of the exchange, cost and market values of the oil were as follows:

	Yola Co.	*Zaro Co.*
Cost	$100,000	$126,000
Market values	120,000	150,000

In Zaro's income statement, what amount of gain should be reported from the exchange of the oil?
a. $0
b. $ 4,800
c. $24,000
d. $30,000

2N91#9. Pine City owned a vacant plot of land zoned for industrial use. Pine gave this land to Medi Corp. solely as an incentive for Medi to build a factory on the site. The land had a fair value of $300,000 at the date of the gift. This nonmonetary transaction should be reported by Medi as
a. Extraordinary income.
b. Additional paid-in capital.
c. A credit to retained earnings.
d. A memorandum entry.

2N90#18. Slad Co. exchanged similar productive assets with Gil Co. and, in addition, paid Gil cash of $100,000. The following information pertains to this exchange:

Assets	*Carrying amounts*	*Fair values*
Relinquished by Gil	$75,000	$140,000
Relinquished by Slad	40,000	40,000

On Slad's books, the assets acquired should be recorded at what amount?
a. $ 75,000
b. $100,000
c. $140,000
d. $175,000

2M90#58. On June 30, 1989, Finn, Inc. exchanged 2,000 shares of Edlow Corp. $30 par value common stock for a patent owned by Bisk Co. The Edlow stock was acquired in 1987 at a cost of $50,000. At the exchange date, Edlow common stock had a fair value of $40 per share, and the patent had a net carrying amount of $100,000 on Bisk's books. Finn should record the patent at
a. $ 50,000
b. $ 60,000
c. $ 80,000
d. $100,000

1M88#50. On March 31, 1988, Winn Company traded in an old machine having a carrying amount of $16,800, and paid a cash difference of $6,000 for a new machine having a total cash price of $20,500. On March 31, 1988, what amount of loss should Winn recognize on this exchange?
a. $0
b. $2,300
c. $3,700
d. $6,000

D. Interim Financial Statements

2M92#12. On June 30, 1991, Mill Corp. incurred a $100,000 net loss from disposal of a business segment. Also, on June 30, 1991, Mill paid $40,000 for property taxes assessed for the calendar year 1991. What amount of the foregoing items should be included in the determination of Mill's net income or loss for the six-month interim period ended June 30, 1991?
a. $140,000
b. $120,000
c. $ 90,000
d. $ 70,000

1N90#55. Farr Corp. had the following transactions during the quarter ended March 31, 1990:

Loss on early extinguishment of debt	$ 70,000
Payment of fire insurance premium for calendar year 1990	100,000

What amount should be included in Farr's income statement for the quarter ended March 31, 1990?

	Extraordinary loss	*Insurance expense*
a.	$70,000	$100,000
b.	$70,000	$ 25,000
c.	$17,500	$ 25,000
d.	$0	$100,000

2M90#43. An inventory loss from a permanent market decline of $360,000 occurred in May 1989. Cox Co. appropriately recorded this loss in May 1989 after its March 31, 1989 quarterly report was issued. What amount of inventory loss should be reported in Cox's quarterly income statement for the three months ended June 30, 1989?

a. $0
b. $ 90,000
c. $180,000
d. $360,000

1N89#49. Harper Co. incurred an apparently permanent inventory loss from market decline of $840,000 during June 1989. What amount of the inventory loss should be recognized in Harper's quarterly income statement for the three months ended June 30, 1989?

a. $210,000
b. $280,000
c. $420,000
d. $840,000

2M89#12. Vilo Corp. has estimated that total depreciation expense for the year ending December 31, 1989 will amount to $60,000, and that 1989 year-end bonuses to employees will total $120,000. In Vilo's interim income statement for the six months ended June 30, 1989, what is the total amount of expense relating to these two items that should be reported?

a. $0
b. $ 30,000
c. $ 90,000
d. $180,000

1N88#46. During the second quarter of 1988, Buzz Company sold a piece of equipment at a $12,000 gain. What portion of the gain should Buzz report in its income statement for the second quarter of 1988?

a. $12,000
b. $ 6,000
c. $ 4,000
d. $0

E. Historical Cost, Constant Dollar Accounting, and Current Cost

2M92#13. The following information pertains to each unit of merchandise purchased for resale by Vend Co.:

March 1, 1991	
Purchase price	$ 8
Selling price	$12
Price level index	110

December 31, 1991	
Replacement cost	$10
Selling price	$15
Price level index	121

Under current cost accounting, what is the amount of Vend's holding gain on each unit of this merchandise?

a. $0
b. $0.80
c. $1.20
d. $2.00

2M90#50. The following assets were among those that appeared on Baird Co.'s books at the end of the year:

Demand bank deposits	$650,000
Net long-term receivables	400,000
Patents and trademarks	150,000

In preparing constant dollar financial statements, how much should Baird classify as monetary assets?

a. $1,200,000
b. $1,050,000
c. $ 800,000
d. $ 650,000

1N89#59. Information with respect to Bruno Co.'s cost of goods sold for 1988 is as follows:

	Historical cost	*Units*
Inventory, 1/1/88	$1,060,000	20,000
Production during 1988	5,580,000	90,000
	6,640,000	110,000
Inventory, 12/31/88	2,520,000	40,000
Cost of goods sold	$4,120,000	70,000

Bruno estimates that the current cost per unit of inventory was $58 at January 1, 1988 and $72 at December 31, 1988. In Bruno's supplementary information restated into average current cost, the cost of goods sold for 1988 should be

a. $5,040,000
b. $4,550,000
c. $4,410,000
d. $4,060,000

2M89#13. The following items were among those that appeared on Rubi Co.'s books at the end of 1988:

Merchandise inventory	$600,000
Loans to employees	20,000

What amount should Rubi classify as monetary assets in preparing constant dollar financial statements?

a. $0
b. $ 20,000
c. $600,000
d. $620,000

1N88#52. At December 31, 1987, Jannis Corp. owned two assets as follows:

	Equipment	*Inventory*
Current cost	$100,000	$80,000
Recoverable amount	$ 95,000	$90,000

Jannis voluntarily disclosed supplementary information about current cost at December 31, 1987. In such a disclosure, at what amount would Jannis report total assets?

a. $175,000
b. $180,000
c. $185,000
d. $190,000

1M88#55. Bart Corp.'s accounting records had the following data relating to cost of goods sold for 1987:

	Amount	*Units*
Inventory, 1/1/87	$ 530,000	20,000
Production during 1987	2,790,000	90,000
	3,320,000	110,000
Inventory, 12/31/87	945,000	30,000
Cost of goods sold	$2,375,000	80,000

The current cost per inventory unit was $30 at January 1, 1987, and $36 at December 31, 1987. In Bart's voluntary supplementary information for 1987, the cost of goods sold restated into average current cost would be

a. $2,490,000
b. $2,520,000
c. $2,580,000
d. $2,640,000

F. Gain Contingencies

2M91#15. On November 1, 1990, Beni Corp. was awarded a judgment of $1,500,000 in connection with a lawsuit. The decision is being appealed by the defendant, and it is expected that the appeal process will be completed by the end of 1991. Beni's attorney feels that it is highly probable that an award will be upheld on appeal, but that the judgment may be reduced by an estimated 40%. In addition to footnote disclosure, what amount should be reported as a receivable in Beni's balance sheet at December 31, 1990?

a. $1,500,000
b. $ 900,000
c. $ 600,000
d. $0

1N90#56. On January 3, 1989, Ard Corp. owned a machine that had cost $60,000. The accumulated depreciation was $50,000, estimated salvage value was $5,000, and fair market value was $90,000. On January 4, 1989, this machine was irreparably damaged by Rice Corp. and became worthless. In October 1989, a court awarded damages of $90,000 against Rice in favor of Ard. At December 31, 1989, the final outcome of this case was awaiting appeal and was, therefore, uncertain. However, in the opinion of Ard's attorney, Rice's appeal will be denied. At December 31, 1989, what amount should Ard accrue for this gain contingency?

a. $90,000
b. $80,000
c. $75,000
d. $0

2M90#60. Dodd Corp. is preparing its December 31, 1989 financial statements and must determine the proper accounting treatment for the following situations:

- For the year ended December 31, 1989, Dodd has a loss carryforward of $180,000 available to offset future taxable income. However, there are no temporary differences.
- On December 30, 1989, Dodd received a $200,000 offer for its patent. Dodd's management is considering whether to sell the patent. The offer expires on February 28, 1990. The patent has a carrying amount of $100,000 at December 31, 1989.

Assume a current and future income tax rate of 30%. In its 1989 income statement, Dodd should recognize an increase in net income of

a. $0
b. $ 54,000
c. $ 70,000
d. $124,000

1N89#60. In May 1985, Croft Co. filed suit against Walton, Inc. seeking $950,000 damages for patent infringement. A court verdict in November 1988 awarded Croft $750,000 in damages, but Walton's appeal is not expected to be decided before 1990. Croft's counsel believes it is probable that Croft will be successful against Walton for an estimated amount in the range between $400,000 and $550,000, with $500,000 considered the most likely amount. What amount should Croft record as revenue from the lawsuit in the year ended December 31, 1988?

a. $750,000
b. $500,000
c. $400,000
d. $0

1N88#53. In October 1987, Swine Corp. filed a lawsuit seeking $100,000 in damages for alleged copyright infringement. On December 31, 1987, with the case still in progress, Swine's attorney asserted that Swine would probably win the suit, but would likely receive $80,000 in damages. On February 1, 1988, before Swine's 1987 financial statements were issued, the suit was settled out of court for $60,000. In its December 31, 1987 financial statements, Swine should report accrued revenue of

a. $0
b. $ 60,000
c. $ 80,000
d. $100,000

1M88#56. For the year ended December 31, 1987, Colt Corp. has a loss carryforward of $180,000 available to offset future taxable income. At December 31, 1987, realization of the tax benefit of the carryforward is probable, but not assured beyond any reasonable doubt. Assume an income tax rate of 30%. What amount of the tax benefit should be reported in Colt's 1987 income statement?

a. $180,000
b. $126,000
c. $ 54,000
d. $0

G. Segments and Lines of Business

2N91#12. Yola Corp., a diversified company, is required to report the operating profit or loss for each of its industry segments. For the year ended December 31, 1990, segment Wy's sales to segment Zee were $100,000. Segment Wy's share of Yola's allocated general corporate expenses was $20,000. In the computation of Wy's 1990 operating profit or loss, the amount of the aforementioned items to be included is

a. $120,000
b. $100,000
c. $ 80,000
d. $ 20,000

2M91#11. The following information pertains to revenue earned by Timm Co.'s industry segments for the year ended December 31, 1990:

Segment	*Sales to unaffiliated customers*	*Intersegment sales*	*Total revenue*
Alo	$ 5,000	$ 3,000	$ 8,000
Bix	8,000	4,000	12,000
Cee	4,000	—	4,000
Dil	43,000	16,000	59,000
Combined	60,000	23,000	83,000
Elimination	—	(23,000)	(23,000)
Consolidated	$60,000	—	$60,000

In conformity with the revenue test, Timm's reportable segments were

a. Only Dil.
b. Only Bix and Dil.
c. Only Alo, Bix, and Dil.
d. Alo, Bix, Cee, and Dil.

2M91#16. Graf Corp. discloses supplemental industry segment information. The following information is available for 1990:

Segment	*Sales*	*Traceable operating expenses*
X	$1,000,000	$ 600,000
Y	800,000	500,000
Z	600,000	350,000
	$2,400,000	$1,450,000

Additional 1990 expenses, not included above, are as follows:

Indirect operating expenses	$360,000
General corporate expenses	240,000

Appropriate common expenses are allocated to segments based on the ratio of a segment's sales to total sales. Segment Z's 1990 operating profit was

a. $100,000
b. $130,000
c. $160,000
d. $250,000

2M90#54. Hyde Corp. has three manufacturing divisions, each of which has been determined to be a reportable segment. Common costs are appropriately allocated on the basis of each division's sales in relation to Hyde's aggregate sales. In 1989, Clay division had sales of $3,000,000, which was 25% of Hyde's total sales, and had traceable operating costs of $1,900,000. In 1989, Hyde incurred operating costs of $500,000 that were not directly traceable to any of the divisions. In addition, Hyde incurred interest expense of $300,000 in 1989. In reporting segment information, what amount should be shown as Clay's operating profit for 1989?

a. $ 875,000
b. $ 900,000
c. $ 975,000
d. $1,100,000

2M90#56. Correy Corp. and its divisions are engaged solely in manufacturing operations. The following data (consistent with prior years' data) pertain to the industries in which operations were conducted for the year ended December 31, 1989:

Industry	*Total revenue*	*Operating profit*	*Identifiable assets at 12/31/89*
A	$10,000,000	$1,750,000	$20,000,000
B	8,000,000	1,400,000	17,500,000
C	6,000,000	1,200,000	12,500,000
D	3,000,000	550,000	7,500,000
E	4,250,000	675,000	7,000,000
F	1,500,000	225,000	3,000,000
	$32,750,000	$5,800,000	$67,500,000

In its segment information for 1989, how many reportable segments does Correy have?

a. Three
b. Four
c. Five
d. Six

H. Employee Benefits

2M92#14. The following information pertains to Lee Corp.'s defined benefit pension plan for 1991:

Service cost	$160,000
Actual and expected gain on plan assets	35,000
Unexpected loss on plan assets related to a 1991 disposal of a subsidiary	40,000
Amortization of unrecognized prior service cost	5,000
Annual interest on pension obligation	50,000

What amount should Lee report as pension expense in its 1991 income statement?

a. $250,000
b. $220,000
c. $210,000
d. $180,000

2M92#15. The following information pertains to Rik Co.'s two employees:

Name	Weekly salary	Number of weeks worked in 1991	Vacation rights vest or accumulate
Ryan	$800	52	Yes
Todd	600	52	No

Neither Ryan nor Todd took the usual two-week vacation in 1991. In Rik's December 31, 1991, financial statements, what amount of vacation expense and liability should be reported?

a. $2,800
b. $1,600
c. $1,400
d. $0

2N91#20. Wall Corp.'s employee stock purchase plan specifies the following:

- For every $1 withheld from employees' wages for the purchase of Wall's common stock, Wall contributes $2.
- The stock is purchased from Wall's treasury stock at market price on the date of purchase.

The following information pertains to the plan's 1990 transactions:

• Employee withholdings for the year	$ 350,000
• Market value of 150,000 shares issued	1,050,000
• Carrying amount of treasury stock issued (cost)	900,000

Before payroll taxes, what amount should Wall recognize as expense in 1990 for the stock purchase plan?

a. $1,050,000
b. $ 900,000
c. $ 700,000
d. $ 550,000

2M91#17. The following information pertains to the 1990 activity of Ral Corp.'s defined benefit pension plan:

Service cost	$300,000
Return on plan assets	80,000
Interest cost on pension benefit obligation	164,000
Amortization of actuarial loss	30,000
Amortization of unrecognized net obligation	70,000

Ral's 1990 pension cost was

a. $316,000
b. $484,000
c. $574,000
d. $644,000

2N90#16. The following information pertains to Seda Co.'s pension plan:

Actuarial estimate of projected benefit obligation at 1/1/89	$72,000
Assumed discount rate	10%
Service costs for 1989	18,000
Pension benefits paid during 1989	15,000

If **no** change in actuarial estimates occurred during 1989, Seda's projected benefit obligation at December 31, 1989 was

a. $64,200
b. $75,000
c. $79,200
d. $82,200

2M90#53. Gavin Co. grants all employees two weeks of paid vacation for each full year of employment. Unused vacation time can be accumulated and carried forward to succeeding years and will be paid at the salaries in effect when vacations are taken or when employment is terminated. There was no employee turnover in 1989. Additional information relating to the year ended December 31, 1989 is as follows:

Liability for accumulated vacations at 12/31/88	$35,000
Pre-1989 accrued vacations taken from 1/1/89 to 9/30/89 (the authorized period for vacations)	20,000
Vacations earned for work in 1989 (adjusted to current rates)	30,000

Gavin granted a 10% salary increase to all employees on October 1, 1989, its annual salary increase date. For the year ended December 31, 1989, Gavin should report vacation pay expense of

a. $45,000
b. $33,500
c. $31,500
d. $30,000

1N89#56. On January 1, 1988, Heath Corp. established an employee stock ownership plan (ESOP). Selected transactions relating to the ESOP during 1988 were as follows:

- On April 1, 1988, Heath contributed $45,000 cash and 3,000 shares of its $10 par value common stock to the ESOP. On this date, the market price of the stock was $18 a share.
- On October 1, 1988, the ESOP borrowed $100,000 from Union National Bank and acquired 6,000 shares of Heath's common stock in the open market at $17 a share. The note is for one year, bears interest at 10%, and is guaranteed by Heath.
- On December 15, 1988, the ESOP distributed 8,000 shares of Heath's common stock to employees of Heath in accordance with the plan formula. On this date, the market price of the stock was $20 a share.

In its 1988 income statement, what amount should Heath report as compensation expense relating to the ESOP?

a. $ 99,000
b. $155,000
c. $199,000
d. $259,000

2M89#19. Ral Corp. has an incentive compensation plan under which a branch manager receives 10% of the branch's income after deduction of the bonus but before deduction of income tax. Branch income for 1988 before the bonus and income tax was $165,000. The tax rate was 30%. The 1988 bonus amounted to

a. $12,600
b. $15,000
c. $16,500
d. $18,000

I. Analysis of Financial Statements

2M92#16. The following computations were made from Clay Co.'s 1991 books:

Number of days' sales in inventory	61
Number of days' sales in trade accounts receivable	33

What was the number of days in Clay's 1991 operating cycle?

a. 33
b. 47
c. 61
d. 94

2M92#17. The following information pertains to Ali Corp. as of and for the year ended December 31, 1991:

Liabilities	$ 60,000
Stockholders' equity	$500,000
Shares of common stock issued and outstanding	10,000
Net income	$ 30,000

During 1991, Ali's officers exercised stock options for 1,000 shares of stock at an option price of $8 per share. What was the effect of exercising the stock options?

a. Debt-to-equity ratio decreased to 12%.
b. Earnings per share increased by $0.33.
c. Asset turnover increased to 5.4%.
d. No ratios were affected.

2M92#18. Zenk Co. wrote off obsolete inventory of $100,000 during 1991. What was the effect of this write-off on Zenk's ratio analysis?

a. Decrease in current ratio but **not** in quick ratio.
b. Decrease in quick ratio but **not** in current ratio.
c. Increase in current ratio but **not** in quick ratio.
d. Increase in quick ratio but **not** in current ratio.

2N91#18. Tod Corp. wrote off $100,000 of obsolete inventory at December 31, 1990. The effect of this write-off was to decrease

a. Both the current and acid-test ratios.
b. Only the current ratio.
c. Only the acid-test ratio.
d. Neither the current nor the acid-test ratios.

2N91#19. Gil Corp. has current assets of $90,000 and current liabilities of $180,000. Which of the following transactions would improve Gil's current ratio?

a. Refinancing a $30,000 long-term mortgage with a short-term note.
b. Purchasing $50,000 of merchandise inventory with a short-term account payable.
c. Paying $20,000 of short-term accounts payable.
d. Collecting $10,000 of short-term accounts receivable.

2M91#18. The following information was extracted from Gil Co.'s December 31, 1990, balance sheet:

Noncurrent assets:	
Long-term investments in marketable equity securities (carried at lower of cost or market)	$96,450
Stockholders' equity:	
Net unrealized loss on long-term investments in marketable equity securities	(19,800)

Historical cost of the long-term investments in marketable equity securities was

a. $ 63,595
b. $ 76,650
c. $ 96,450
d. $116,250

1N90#57. During 1989, Rand Co. purchased $960,000 of inventory. The cost of goods sold for 1989 was $900,000, and the ending inventory at December 31,

1989 was $180,000. What was the inventory turnover for 1989?
a. 6.4
b. 6.0
c. 5.3
d. 5.0

2M90#55. The following data pertain to Ruhl Corp.'s operations for the year ended December 31, 1989:

Operating income	$800,000
Interest expense	100,000
Income before income tax	700,000
Income tax expense	210,000
Net income	$490,000

The times interest earned ratio is
a. 8.0 to 1
b. 7.0 to 1
c. 5.6 to 1
d. 4.9 to 1

1N89#57. The following data pertain to Thorne Corp. for the calendar year 1988:

Net income	$240,000
Dividends paid on common stock	120,000
Common stock outstanding (unchanged during year)	300,000 shares

The market price per share of Thorne's common stock at December 31, 1988 was $12. The price-earnings ratio at December 31, 1988 was
a. 9.6 to 1
b. 10.0 to 1
c. 15.0 to 1
d. 30.0 to 1

2M89
Items 14 and 15 are based on the following:

Rey, Inc.
Selected Financial Data
December 31,

	1988	*1987*
Cash	$ 170,000	$ 90,000
Accounts receivable (net)	450,000	400,000
Merchandise inventory	540,000	420,000
Short-term marketable securities	80,000	40,000
Land and building (net)	1,000,000	1,000,000
Mortgage payable — current portion	60,000	50,000
Accounts payable and accrued liabilities	240,000	220,000
Short-term notes payable	100,000	140,000

Net credit sales totaled $3,000,000 and $2,000,000 for the years ended December 31, 1988 and 1987, respectively.

14. At December 31, 1988, Rey's quick (acid test) ratio was
a. 1.50 to 1
b. 1.75 to 1
c. 2.06 to 1
d. 3.10 to 1

15. For 1988, Rey's accounts receivable turnover was
a. 1.13
b. 1.50
c. 6.67
d. 7.06

1N88#49. The following information is available from Timber Corp.'s financial records for 1987:

Sales	
Net credit sales	$500,000
Net cash sales	250,000
	$750,000
Accounts Receivable	
Balance, January 1, 1987	$ 75,000
Balance, December 31, 1987	50,000

How many times did Timber's accounts receivable turn over in 1987?
a. 15
b. 12
c. 10
d. 8

1M88#57. Selected information for Cain Corp. for the year ended December 31, 1987 follows:

Average days' sales in inventories	124
Average days' sales in accounts receivable	48

The average number of days in the operating cycle for 1987 was
a. 172
b. 124
c. 86
d. 76

J. Development Stage Enterprises

1N90#58. Lex Corp. was a development stage enterprise from October 10, 1987 (inception) to December 31, 1988. The year ended December 31, 1989 is the first year in which Lex is an established operating enterprise. The following are among the costs incurred by Lex:

	For the period 10/10/87 to 12/31/88	For the year ended 12/31/89
Leasehold improvements, equipment, and furniture	$1,000,000	$ 300,000
Security deposits	60,000	30,000
Research and development	750,000	900,000
Laboratory operations	175,000	550,000
General and administrative	225,000	685,000
Depreciation	25,000	115,000
	$2,235,000	$2,580,000

From its inception through the period ended December 31, 1989, what is the total amount of costs incurred by Lex that should be charged to operations?

a. $3,425,000
b. $2,250,000
c. $1,775,000
d. $1,350,000

2M90#52. Lind Corp. was a development stage enterprise from its inception on October 10, 1987 to December 31, 1988. The following were among Lind's expenditures for this period:

Leasehold improvements, equipment, and furniture	$1,200,000
Research and development	850,000
Laboratory operations	175,000
General and administrative	275,000

The year ended December 31, 1989 was the first year in which Lind was an established operating enterprise. For the period ended December 31, 1988, what total amount of expenditures should Lind have capitalized?

a. $2,500,000
b. $2,225,000
c. $2,050,000
d. $1,200,000

1N89#4. Chester Corp. was a development stage enterprise from its inception on September 1, 1987 to December 31, 1988. The following information was taken from Chester's accounting records for the above period:

Net sales	$1,350,000
Cost of sales	1,000,000
Selling, general, and administrative expenses	400,000
Research and development costs	300,000
Interest expense	100,000

For the period September 1, 1987 to December 31, 1988, what amount should Chester report as net loss?

a. $ 50,000
b. $150,000
c. $350,000
d. $450,000

1N88#55. On July 2, 1988, Creighton Corp. was formed for the purpose of presenting a musical comedy show. The show was scheduled to be presented only on December 30, 1988. A total of 1,000 tickets were sold between July 2 and December 30, including 50 tickets sold between July 2 and July 31. During July, Creighton paid $12,000 in salaries to actors involved in rehearsals during that month. On July 31, Creighton was considered to be in the development stage of its principal operation. In an income statement prepared for the period July 2 through July 31, 1988, Creighton should report salary expense of

a. $0
b. $ 600
c. $ 2,000
d. $12,000

1M88

Items 58 and 59 are based on the following information:

Towne Systems Corp. was a development stage enterprise from October 10, 1985 (inception) to December 31, 1986. The year ended December 31, 1987 is the first year in which Towne is an established operating enterprise. The following are among the costs incurred by Towne:

	For the period 10/10/85 to 12/31/86	For the year ended 12/31/87
Leasehold improvements, equipment, and furniture	$1,000,000	$150,000
Security deposits	60,000	15,000
Research and development	750,000	450,000
Laboratory operations	175,000	275,000
General and administrative	250,000	400,000

58. For the period ended December 31, 1986, what total amount of the costs incurred should Towne have capitalized?

a. $1,060,000
b. $1,810,000
c. $1,985,000
d. $2,235,000

59. For the year ended December 31, 1987, what total amount of the costs incurred should Towne have capitalized?

a. $875,000
b. $615,000
c. $165,000
d. $150,000

K. Personal Financial Statements

2M92#19. Shea, a calendar-year taxpayer, is preparing a personal statement of financial condition as of April 30, 1992. Shea's 1991 income tax liability was paid in full on April 15, 1992. Shea's tax on income earned from January through April 1992 is estimated at $30,000. In addition, $25,000 is estimated for income tax on the differences between the estimated current values of Shea's assets and the current amounts of liabilities and their tax bases at April 30, 1992. No withholdings or payments have been made towards the 1992 income tax liability. In Shea's statement of financial condition at April 30, 1992, what is the total of the amount or amounts that should be reported for income taxes?

a. $0
b. $25,000
c. $30,000
d. $55,000

2N91#14. Ely had the following personal investments at December 31, 1990:

- Realty held as a limited business activity not conducted in a separate business entity. Mortgage payments were made with funds from sources unrelated to the realty. The cost of this realty was $500,000, and the related mortgage payable was $100,000 at December 31, 1990.
- Sole proprietorship marketable as a going concern. Its cost was $900,000, and it had related accounts payable of $80,000 at December 31, 1990.

The costs of both investments equal estimated current values. The balances of liabilities equal their estimated current amounts.

How should the foregoing information be reported in Ely's statement of financial condition at December 31, 1990?

	Assets	*Liabilities*
a. Investment in real estate	$ 400,000	
Investment in sole proprietorship	820,000	
b. Investment in real estate	$ 500,000	
Investment in sole proprietorship	820,000	
Mortgage payable		$100,000
c. Investment in real estate	$ 500,000	
Investment in sole proprietorship	900,000	
Mortgage payable		$100,000
Accounts payable		80,000
d. Investments	$1,400,000	
Accounts and mortgage payable		$180,000

2N91#15. At December 31, 1990, Ryan had the following noncancelable personal commitments:

- Pledge to be paid to County Welfare Home 30 days after volunteers paint the walls and ceiling of the Home's recreation room $ 5,000
- Pledge to be paid to City Hospital on the recovery of Ryan's comatose sister 25,000

What amount should be included in liabilities in Ryan's personal statement of financial condition at December 31, 1990?

a. $0
b. $ 5,000
c. $25,000
d. $30,000

2N91#16. The following information pertains to Smith's personal assets and liabilities at December 31, 1990:

	Historical cost	*Estimated current values*	*Estimated current amounts*
Assets	$500,000	$900,000	
Liabilities	100,000		$80,000

Smith's 1990 income tax rate was 30%. In Smith's personal statement of financial condition at December 31, 1990, what amount should be reported as Smith's net worth?

a. $294,000
b. $420,000
c. $694,000
d. $820,000

2M91#8. Moran is preparing a personal statement of financial condition as of April 30, 1991. Included in Moran's assets are the following:

- 50% of the voting stock of Crow Corp. A stockholders' agreement restricts the sale of the stock and, under certain circumstances, requires Crow to repurchase the stock based on carrying amounts of net assets plus an agreed amount for goodwill. At April 30, 1991, the buyout value of this stock is $337,500. Moran's tax basis for the stock is $215,000.
- Jewelry with a fair value aggregating $35,000 based on an independent appraisal on April 30, 1991, for insurance purposes. This jewelry was acquired by purchase and gift over a 10-year period and has a total tax basis of $20,000.

At what total amount should the Crow stock and jewelry be reported in Moran's April 30, 1991, personal statement of financial condition?

a. $372,500
b. $357,500
c. $250,000
d. $235,000

2M91#9. The following information pertains to marketable equity securities owned by Kent:

Stock	Fair value at December 31, 1990	1989	Cost in 1988
City Mfg., Inc.	$95,500	$93,000	$89,900
Tri Corp.	3,400	5,600	3,600
Zee, Inc.		10,300	15,000

The Zee stock was sold in January 1990 for $10,200. In Kent's personal statement of financial condition at December 31, 1990, what amount should be reported for marketable equity securities?

a. $93,300
b. $93,500
c. $94,100
d. $98,900

2M91#10. The estimated current values of Lane's personal assets at December 31, 1990, totaled $1,000,000, with tax bases aggregating $600,000. Included in these assets was a vested interest in a deferred profit-sharing plan with a current value of $80,000 and a tax basis of $70,000. The estimated current amounts of Lane's personal liabilities equaled their tax bases at December 31, 1990. Lane's 1990 effective income tax rate was 30%. In Lane's personal statement of financial condition at December 31, 1990, what amount should be provided for estimated income taxes relating to the excess of current values over tax bases?

a. $120,000
b. $117,000
c. $ 3,000
d. $0

1N90#59. Mrs. Taft owns a $150,000 insurance policy on her husband's life. The cash value of the policy is $125,000, and there is a $50,000 loan against the policy. In the Tafts' personal statement of financial condition at December 31, 1989, what amount should be shown as an investment in life insurance?

a. $150,000
b. $125,000
c. $100,000
d. $ 75,000

2M90#59. Dale Hall's holdings at December 31, 1989 included the following:

- 5,000 shares of Arno Corp. common stock purchased in 1984 for $85,000. The market value of the stock was $120,000 at December 31, 1989.
- A life insurance policy with a cash value of $50,000 at December 31, 1989.

In Hall's December 31, 1989 personal statement of financial condition, the above items should be reported at

a. $170,000
b. $135,000
c. $120,000
d. $ 85,000

1N89#58. John Holt owns 50% of the common stock of Brett Corp. Holt paid $25,000 for this stock in 1983. At December 31, 1988, it was ascertained that Holt's 50% stock ownership in Brett had a current value of $185,000. Brett's cumulative net income and cash dividends declared for the five years ended December 31, 1988 were $300,000 and $30,000 respectively. In Holt's personal statement of financial condition at December 31, 1988, what amount should be reported as his net investment in Brett?

a. $ 25,000
b. $160,000
c. $175,000
d. $185,000

2M89#17. Ron Alda owns 100% of Hako Corp.'s outstanding capital stock. Alda paid $60,000 for this stock in 1980. At December 31, 1988, the book value of Hako's net assets amounted to $300,000. It has been ascertained that Alda's 100% stock ownership in Hako had a current value of $500,000 at December 31, 1988. Alda has an employment contract with Hako under which Alda is to receive a salary of $100,000 annually for a ten-year period beginning in January 1988. In Alda's personal statement of financial condition at December 31, 1988, what amount should be shown as his net investment in Hako?

a. $ 60,000
b. $100,000
c. $300,000
d. $500,000

1N88#59. On December 31, 1987, Shane is a fully vested participant in a company-sponsored pension plan. According to the plan's administrator, Shane has at that date the nonforfeitable right to receive a lump sum of $100,000 on December 28, 1988. The discounted amount of $100,000 is $90,000 at December 31, 1987. The right is not contingent on Shane's life expectancy and requires no future performance on Shane's part. In Shane's December 31, 1987 personal statement of financial condition, the vested interest in the pension plan should be reported at

a. $0
b. $ 90,000
c. $ 95,000
d. $100,000

1M88#60. On December 31, 1987, Mr. and Mrs. Blake owned a parcel of land held as an investment. The land was purchased for $95,000 in 1980, and was encumbered by a mortgage with a principal balance of $60,000 at December 31, 1987. On this date the fair value of the land was $150,000. In the Blakes' December 31, 1987 personal statement of financial condition, at what amount should the land investment and mortgage payable be reported?

	Land investment	*Mortgage payable*
a.	$150,000	$60,000
b.	$ 95,000	$60,000
c.	$ 90,000	$0
d.	$ 35,000	$0

L. Combined Financial Statements

2M92#20. Ahm Corp. owns 90% of Bee Corp.'s common stock and 80% of Cee Corp.'s common stock. The remaining common shares of Bee and Cee are owned by their respective employees. Bee sells exclusively to Cee, Cee buys exclusively from Bee, and Cee sells exclusively to unrelated companies. Selected 1991 information for Bee and Cee follows:

	Bee Corp.	*Cee Corp.*
Sales	$130,000	$ 91,000
Cost of sales	100,000	65,000
Beginning inventory	None	None
Ending inventory	None	65,000

What amount should be reported as gross profit in Bee and Cee's combined income statement for the year ended December 31, 1991?

a. $26,000
b. $41,000
c. $47,800
d. $56,000

2N91#17. Mill Corp. acquired Vore Corp. in a business combination. At the acquisition date, Vore's plant and equipment had a carrying amount of $750,000 and a fair value of $875,000. What amount should the combined entity report for Vore's plant and equipment under each of the following methods at the date of acquisition?

	Pooling of interests	*Purchase*
a.	$750,000	$875,000
b.	$750,000	$750,000
c.	$875,000	$875,000
d.	$875,000	$750,000

2M91
Items 19 and 20 are based on the following:

Nolan owns 100% of the capital stock of both Twill Corp. and Webb Corp. Twill purchases merchandise inventory from Webb at 140% of Webb's cost. During 1990, merchandise that cost Webb $40,000 was sold to Twill. Twill sold all of this merchandise to unrelated customers for $81,200 during 1990. In preparing combined financial statements for 1990, Nolan's bookkeeper disregarded the common ownership of Twill and Webb.

19. By what amount was unadjusted revenue overstated in the combined income statement for 1990?

a. $16,000
b. $40,000
c. $56,000
d. $81,200

20. What amount should be eliminated from cost of goods sold in the combined income statement for 1990?

a. $56,000
b. $40,000
c. $24,000
d. $16,000

1N90#60. Mr. Cord owns four corporations. Combined financial statements are being prepared for these corporations, which have intercompany loans of $200,000 and intercompany profits of $500,000. What amount of these intercompany loans and profits should be included in the combined financial statements?

	Intercompany	
	Loans	*Profits*
a.	$200,000	$0
b.	$200,000	$500,000
c.	$0	$0
d.	$0	$500,000

1N89#55. Selected data for two subsidiaries of Dunn Corp. taken from December 31, 1988 pre-closing trial balances are as follows:

	Banks Co. Debit	*Lamm Co. Credit*
Shipments to Banks	$ —	$150,000
Shipments from Lamm	200,000	—
Intercompany inventory profit on total shipments	—	50,000

Additional data relating to the December 31, 1988 inventory are as follows:

Inventory acquired from outside parties	$175,000	$250,000
Inventory acquired from Lamm	60,000	—

At December 31, 1988, the inventory reported on the combined balance sheet of the two subsidiaries should be

a. $425,000
b. $435,000
c. $470,000
d. $485,000

1N88#58. At December 31, 1987, Spud Corp. owned 80% of Jenkins Corp.'s common stock and 90% of Thompson Corp.'s common stock. Jenkins' 1987 net income was $100,000 and Thompson's 1987 net income was $200,000. Thompson and Jenkins had no intercompany ownership or transactions during 1987. Combined 1987 financial statements are being prepared for Thompson and Jenkins in contemplation of their sale to an outside party. In the combined income statement, combined net income should be reported at

a. $210,000
b. $260,000
c. $280,000
d. $300,000

1M88#53. Mr. and Mrs. Gasson own 100% of the common stock of Able Corp. and 90% of the common stock of Baker Corp. Able previously paid $4,000 for the remaining 10% interest in Baker. The condensed December 31, 1987 balance sheets of Able and Baker are as follows:

	Able	*Baker*
Assets	$600,000	$60,000
Liabilities	$200,000	$30,000
Common stock	100,000	20,000
Retained earnings	300,000	10,000
	$600,000	$60,000

In a combined balance sheet of the two corporations at December 31, 1987, what amount should be reported as total stockholders' equity?

a. $430,000
b. $426,000
c. $403,000
d. $400,000

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

2M92#41. During the month of March 1992, Nale Co. used $300,000 of direct materials. At March 31, 1992, Nale's direct materials inventory was $50,000 more than it was at March 1, 1992. Direct material purchases during the month of March 1992 amounted to

a. $0
b. $250,000
c. $300,000
d. $350,000

2M92#42. Fab Co. manufactures textiles. Among Fab's 1991 manufacturing costs were the following salaries and wages:

Loom operators	$120,000
Factory foremen	45,000
Machine mechanics	30,000

What was the amount of Fab's 1991 direct labor?

a. $195,000
b. $165,000
c. $150,000
d. $120,000

2M92#43. The following were among Gage Co.'s 1991 costs:

Normal spoilage	$ 5,000
Freight out	10,000
Excess of actual manufacturing costs over standard costs	20,000
Standard manufacturing costs	100,000
Actual prime manufacturing costs	80,000

Gage's 1991 actual manufacturing overhead was

a. $ 40,000
b. $ 45,000
c. $ 55,000
d. $120,000

2N89

Items 33 through 35 are based on the following information pertaining to Arp Co.'s manufacturing operations:

Inventories	*3/1/89*	*3/31/89*
Direct materials	$36,000	$30,000
Work-in-process	18,000	12,000
Finished goods	54,000	72,000

Additional information for the month of March 1989:

Direct materials purchased	$84,000
Direct labor payroll	60,000
Direct labor rate per hour	7.50
Factory overhead rate per direct labor hour	10.00

33. For the month of March 1989, prime cost was
    a. $ 90,000
    b. $120,000
    c. $144,000
    d. $150,000

34. For the month of March 1989, conversion cost was
    a. $ 90,000
    b. $140,000
    c. $144,000
    d. $170,000

35. For the month of March 1989, cost of goods manufactured was
    a. $218,000
    b. $224,000
    c. $230,000
    d. $236,000

B. Process and Job Order Costing

2M92#44. Birk Co. uses a job order cost system. The following debits (credits) appeared in Birk's work-in-process account for the month of April 1992:

April	*Description*	*Amount*
1	Balance	$ 4,000
30	Direct materials	24,000
30	Direct labor	16,000
30	Factory overhead	12,800
30	To finished goods	(48,000)

Birk applies overhead to production at a predetermined rate of 80% of direct labor cost. Job No. 5, the only job still in process on April 30, 1992, has been charged with direct labor of $2,000. What was the amount of direct materials charged to Job No. 5?
    a. $ 3,000
    b. $ 5,200
    c. $ 8,800
    d. $24,000

2M92#45. Yarn Co.'s inventories in process were at the following stages of completion at April 30, 1992:

No. of units	*Percent complete*
100	90
50	80
200	10

Equivalent units of production amounted to
    a. 150
    b. 180
    c. 330
    d. 350

C. Standard Costing

2M92#46. The following direct labor information pertains to the manufacture of product Glu:

Time required to make one unit	2 direct labor hours
Number of direct workers	50
Number of productive hours per week, per worker	40
Weekly wages per worker	$500
Workers' benefits treated as direct labor costs	20% of wages

What is the standard direct labor cost per unit of product Glu?
    a. $30
    b. $24
    c. $15
    d. $12

2N89#26. Dahl Co. uses a standard costing system in connection with the manufacture of a "one size fits all" article of clothing. Each unit of finished product contains 2 yards of direct material. However, a 20% direct material spoilage calculated on input quantities occurs during the manufacturing process. The cost of the direct material is $3 per yard. The standard direct material cost per unit of finished product is
    a. $4.80
    b. $6.00
    c. $7.20
    d. $7.50

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

2M92#47. The following information pertains to a by-product called Moy:

Sales in 1991	5,000 units
Selling price per unit	$6
Selling costs per unit	2
Processing costs	0

Inventory of Moy was recorded at net realizable value when produced in 1990. No units of Moy were produced in 1991. What amount should be recognized as profit on Moy's 1991 sales?
    a. $0
    b. $10,000
    c. $20,000
    d. $30,000

2M92#48. Hoyt Co. manufactured the following units:

Saleable	5,000
Unsaleable (normal spoilage)	200
Unsaleable (abnormal spoilage)	300

Manufacturing costs totaled $99,000. What amount should Hoyt debit to finished goods?

a. $90,000
b. $93,600
c. $95,400
d. $99,000

2N89#32. In manufacturing its products for the month of March 1989, Elk Co. incurred normal spoilage of $5,000 and abnormal spoilage of $9,000. How much spoilage cost should Elk charge as a period cost for the month of March 1989?

a. $0
b. $ 5,000
c. $ 9,000
d. $14,000

E. Absorption and Variable Costing

2M92#49. At the end of Killo Co.'s first year of operations, 1,000 units of inventory remained on hand. Variable and fixed manufacturing costs per unit were $90 and $20, respectively. If Killo uses absorption costing rather than direct (variable) costing, the result would be a higher pretax income of

a. $0
b. $20,000
c. $70,000
d. $90,000

2N89#29. West Co.'s 1988 manufacturing costs were as follows:

Direct materials and direct labor	$700,000
Other variable manufacturing costs	100,000
Depreciation of factory building and manufacturing equipment	80,000
Other fixed manufacturing overhead	18,000

What amount should be considered product cost for external reporting purposes?

a. $700,000
b. $800,000
c. $880,000
d. $898,000

2N89#30. During the month of April, Vane Co. produced and sold 10,000 units of a product. Manufacturing and selling costs incurred during April were as follows:

Direct materials and direct labor	$400,000
Variable manufacturing overhead	90,000
Fixed manufacturing overhead	20,000
Variable selling costs	10,000

The product's unit cost under direct (variable) costing was

a. $49
b. $50
c. $51
d. $52

F. Budgeting and Flexible Budgeting

2N89#31. In preparing its cash budget for May 1989, Ben Co. made the following projections:

Sales	$3,000,000
Gross margin (based on sales)	25%
Decrease in inventories	140,000
Decrease in accounts payable for inventories	240,000

For May 1989, the estimated cash disbursements for inventories were

a. $2,350,000
b. $2,110,000
c. $2,100,000
d. $1,870,000

G. Breakeven and Cost-Volume-Profit Analysis

2M92#50. The following information pertains to Clove Co. for the year ending December 31, 1992:

Budgeted sales	$1,000,000
Breakeven sales	700,000
Budgeted contribution margin	600,000
Cashflow breakeven	200,000

Clove's margin of safety is

a. $300,000
b. $400,000
c. $500,000
d. $800,000

2N89#27. The following information pertains to Sisk Co.:

Sales (25,000 units)	$500,000
Direct materials and direct labor	150,000
Factory overhead:	
Variable	20,000
Fixed	35,000
Selling and general expenses:	
Variable	5,000
Fixed	30,000

Sisk's breakeven point in number of units is

a. 4,924
b. 5,000
c. 6,250
d. 9,286

H. Capital Budgeting Techniques

2M92
Items 57 through 60 are based on the following:

Tam Co. is negotiating for the purchase of equipment that would cost $100,000, with the expectation that $20,000 per year could be saved in after-tax cash costs if the equipment were acquired. The equipment's estimated useful life is 10 years, with no residual value, and would be depreciated by the straight-line method. Tam's predetermined minimum desired rate of return is 12%. Present value of an annuity of 1 at 12% for 10 periods is 5.65. Present value of 1 due in 10 periods at 12% is .322.

57. Net present value is
 a. $ 5,760
 b. $ 6,440
 c. $12,200
 d. $13,000

58. Payback period is
 a. 4.0 years
 b. 4.4 years
 c. 4.5 years
 d. 5.0 years

59. Accrual accounting rate of return based on initial investment is
 a. 30%
 b. 20%
 c. 12%
 d. 10%

60. In estimating the internal rate of return, the factors in the table of present values of an annuity should be taken from the columns closest to
 a. 0.65
 b. 1.30
 c. 5.00
 d. 5.65

2N89#36. Kern Co. is planning to invest in a two-year project that is expected to yield cash flows from operations, net of income taxes, of $50,000 in the first year and $80,000 in the second year. Kern requires an internal rate of return of 15%. The present value of $1 for one period at 15% is 0.870 and for two periods at 15% is 0.756. The future value of $1 for one period at 15% is 1.150 and for two periods at 15% is 1.323. The maximum that Kern should invest immediately is
 a. $ 81,670
 b. $103,980
 c. $130,000
 d. $163,340

2N89#40. Doro Co. is considering the purchase of a $100,000 machine that is expected to result in a decrease of $25,000 per year in cash expenses after taxes. This machine, which has no residual value, has an estimated useful life of 10 years and will be depreciated on a straight-line basis. For this machine, the accounting rate of return based on initial investment would be
 a. 10%
 b. 15%
 c. 25%
 d. 35%

I. Performance Analysis

2M92#51. The following is a summarized income statement of Carr Co.'s profit center No. 43 for March 1992:

Contribution margin		$70,000
Period expenses:		
Manager's salary	$20,000	
Facility depreciation	8,000	
Corporate expense allocation	5,000	33,000
Profit center income		$37,000

Which of the following amounts would most likely be subject to the control of the profit center's manager?
 a. $70,000
 b. $50,000
 c. $37,000
 d. $33,000

2M92#52. Following is information relating to Kew Co.'s Vale Division for 1991:

Sales	$500,000
Variable costs	300,000
Traceable fixed costs	50,000
Average invested capital	100,000
Imputed interest rate	6%

Vale's residual income was
 a. $144,000
 b. $150,000
 c. $156,000
 d. $200,000

2M92#53. The following information pertains to Bala Co. for the year ended December 31, 1991:

Sales	$600,000
Net income	100,000
Capital investment	400,000

Which of the following equations should be used to compute Bala's return on investment?
 a. $(4/6) \times (6/1) =$ ROI
 b. $(6/4) \times (1/6) =$ ROI
 c. $(4/6) \times (1/6) =$ ROI
 d. $(6/4) \times (6/1) =$ ROI

2N89

Items 37 and 38 are based on the following information pertaining to Yola Co.'s East Division for 1988:

Sales	$620,000
Variable costs	500,000
Traceable fixed costs	100,000
Average invested capital	50,000
Imputed interest rate	18%

37. The return on investment was
    a. 40.00%
    b. 29.00%
    c. 18.00%
    d. 8.33%

38. The residual income was
    a. $ 3,600
    b. $ 9,000
    c. $11,000
    d. $20,000

J. Other

2M92#54. Box Co. uses regression analysis to estimate the functional relationship between an independent variable (cost driver) and overhead cost. Assume that the following equation is being used:

$$y = A + Bx$$

What is the symbol for the independent variable?
a. y
b. x
c. Bx
d. A

2M92#55. Kane Corp. estimates that it would incur a $100,000 cost to prepare a bid proposal. Kane estimates also that there would be an 80% chance of being awarded the contract if the bid is low enough to result in a net profit of $250,000. What is the expected value of the payoff?
a. $0
b. $150,000
c. $180,000
d. $220,000

2M92#56. For the year ended December 31, 1991, Abel Co. incurred direct costs of $500,000 based on a particular course of action during the year. If a different course of action had been taken, direct costs would have been $400,000. In addition, Abel's 1991 fixed costs were $90,000. The incremental cost was
a. $ 10,000
b. $ 90,000
c. $100,000
d. $190,000

2N89#21. The following information pertains to three shipping terminals operated by Krag Corp.:

Terminal	*Percentage of cargo handled*	*Percentage of error*
Land	50	2
Air	40	4
Sea	10	14

Krag's internal auditor randomly selects one set of shipping documents, ascertaining that the set selected contains an error. The probability that the error occurred in the Land Terminal is
a. 2%
b. 10%
c. 25%
d. 50%

2N89#22. Mili Co. plans to discontinue a division with a $20,000 contribution to overhead. Overhead allocated to the division is $50,000, of which $5,000 cannot be eliminated. The effect of this discontinuance on Mili's pretax income would be an increase of
a. $ 5,000
b. $20,000
c. $25,000
d. $30,000

2N89#23. Diva Co. wants to establish a selling price that will yield a gross margin of 40% on sales of a product whose cost is $12.00 per unit. The selling price should be
a. $16.80
b. $19.20
c. $20.00
d. $30.00

2N89#25. The following information appeared in the accounting records of a retail store for the year ended December 31, 1988:

Sales	$300,000
Purchases	140,000
Inventories	
January 1	70,000
December 31	100,000
Sales commissions	10,000

The gross margin was
a. $190,000
b. $180,000
c. $160,000
d. $150,000

VIII. Not-for-Profit and Governmental Accounting

A. Fund Accounting

2M92#21. Pine City's year end is June 30. Pine levies property taxes in January of each year for the calendar year. One-half of the levy is due in May and one-half is due in October. Property tax revenue is budgeted for the period in which payment is due. The following information pertains to Pine's property taxes for the period from July 1, 1990, to June 30, 1991:

	Calendar year	
	1990	*1991*
Levy	$2,000,000	$2,400,000
Collected in:		
May	950,000	1,100,000
July	50,000	60,000
October	920,000	
December	80,000	

The $40,000 balance due for the May 1991 installments was expected to be collected in August 1991. What amount should Pine recognize for property tax revenue for the year ended June 30, 1991?

a. $2,160,000
b. $2,200,000
c. $2,360,000
d. $2,400,000

2M92#22. Maple City's public employee retirement system (PERS) reported the following account balances at June 30, 1991:

Reserve for employer's contributions	$5,000,000
Actuarial deficiency in reserve for employer's contributions	300,000
Reserve for employees' contributions	9,000,000

Maple's PERS fund balance at June 30, 1991, should be

a. $ 5,000,000
b. $ 5,300,000
c. $14,000,000
d. $14,300,000

2M92
Items 23 through 25 are based on the following:

Park City uses encumbrance accounting and formally integrates its budget into the general fund's accounting records. For the year ending July 31, 1992, the following budget was adopted:

Estimated revenues	$30,000,000
Appropriations	27,000,000
Estimated transfer to debt service fund	900,000

23. When Park's budget is adopted and recorded, Park's budgetary fund balance would be a

a. $3,000,000 credit balance.
b. $3,000,000 debit balance.
c. $2,100,000 credit balance.
d. $2,100,000 debit balance.

24. Park should record budgeted appropriations by a

a. Credit to appropriations control, $27,000,000.
b. Debit to estimated expenditures, $27,000,000.
c. Credit to appropriations control, $27,900,000.
d. Debit to estimated expenditures, $27,900,000.

25. Park incurred salaries and wages of $800,000 for the month of April 1992. What account should Park debit to record this $800,000?

a. Encumbrances control.
b. Salaries and wages expense control.
c. Expenditures control.
d. Operating funds control.

2N90#46. The following information pertains to Pine City's general fund for 1989:

Appropriations	$6,500,000
Expenditures	5,000,000
Other financing sources	1,500,000
Other financing uses	2,000,000
Revenues	8,000,000

After Pine's general fund accounts were closed at the end of 1989, the fund balance increased by

a. $3,000,000
b. $2,500,000
c. $1,500,000
d. $1,000,000

2N90#50. Harbor City's appropriations control account at December 31, 1989 had a balance of $7,000,000. When the budgetary accounts were closed at year-end, this $7,000,000 appropriations control balance should have

a. Been debited.
b. Been credited.
c. Remained open.
d. Appeared as a contra account.

2N90#51. The following revenues were among those reported by Ariba Township in 1989:

Net rental revenue (after depreciation) from a parking garage owned by Ariba	$ 40,000
Interest earned on investments held for employees' retirement benefits	100,000
Property taxes	6,000,000

What amount of the foregoing revenues should be accounted for in Ariba's governmental-type funds?

a. $6,140,000
b. $6,100,000
c. $6,040,000
d. $6,000,000

2N90#54. The following information pertains to Cobb City:

• 1989 governmental fund revenues that became measurable and available in time to be used for payment of 1989 liabilities	$16,000,000
• Revenues earned in 1987 and 1988 and included in the $16,000,000 indicated above	2,000,000
• Sales taxes collected by merchants in 1989 but not required to be remitted to Cobb until January 1990	3,000,000

For the year ended December 31, 1989, Cobb should recognize revenues of

a. $14,000,000
b. $16,000,000
c. $17,000,000
d. $19,000,000

2N90#55. Oro County's expenditures control account at December 31, 1989 had a balance of $9,000,000. When Oro's books were closed, this $9,000,000 expenditures control balance should have

a. Been debited.
b. Been credited.
c. Remained open.
d. Appeared as a contra account.

2N90#56. At December 31, 1989, Alto Township's committed appropriations that had not been expended in 1989 totaled $10,000. These appropriations do not lapse at year-end. Alto reports on a calendar-year basis. On its December 31, 1989 balance sheet, the $10,000 should be reported as

a. Vouchers payable — prior year.
b. Deferred expenditures.
c. Fund balance reserved for encumbrances.
d. Budgetary fund balance — reserved for encumbrances.

2N90#57. When Rolan County adopted its budget for the year ending June 30, 1990, $20,000,000 was recorded for estimated revenues control. Actual revenues for the year ended June 30, 1990 amounted to $17,000,000. In closing the budgetary accounts at June 30, 1990,

a. Revenues control should be debited for $3,000,000.
b. Estimated revenues control should be debited for $3,000,000.
c. Revenues control should be credited for $20,000,000.
d. Estimated revenues control should be credited for $20,000,000.

2M89

Items 21 through 26 are based on the following:

Cliff Township's fiscal year ends on July 31. Cliff uses encumbrance accounting. On October 2, 1988, an approved $5,000 purchase order was issued for supplies. Cliff received these supplies on November 2, 1988, and the $5,000 invoice was approved for payment by the general fund.

During the year ended July 31, 1989, Cliff received a state grant of $150,000 to finance the purchase of a senior citizens recreation bus, and an additional $15,000 grant to be used for bus operations during the year ended July 31, 1989. Only $125,000 of the capital grant was used during the year ended July 31, 1989 for the bus purchase, but the entire operating grant of $15,000 was disbursed during the year.

Cliff's governing body adopted its general fund budget for the year ending July 31, 1990, comprising estimated revenues of $50,000,000 and appropriations of $40,000,000. Cliff formally integrates its budget into the accounting records.

21. What accounts should Cliff debit and credit on October 2, 1988 to record the approved $5,000 purchase order?

	Debit	*Credit*
a.	Encumbrances control	Appropriations control
b.	Appropriations control	Encumbrances control
c.	Encumbrances control	Budgetary fund balance — reserved for encumbrances
d.	Budgetary fund balance — reserved for encumbrances	Encumbrances control

22. What accounts should Cliff debit and credit on November 2, 1988 upon receipt of the supplies and approval of the $5,000 invoice?

	Debit	*Credit*
a.	Budgetary fund balance — reserved for encumbrances	Encumbrances control
	Expenditures control	Vouchers payable
b.	Encumbrances control	Budgetary fund balance — reserved for encumbrances
	Appropriations control	Vouchers payable

c. Appropriations control	Encumbrances control
Supplies inventory	Vouchers payable
d. Encumbrances control	Appropriations control
Expenditures control	Vouchers payable

23. The senior citizens recreation bus program is accounted for as part of Cliff's general fund. What amount should Cliff report as grant revenues for the year ended July 31, 1989 in connection with the state grants?
   a. $165,000
   b. $150,000
   c. $140,000
   d. $125,000

24. When Cliff records budgeted revenues, estimated revenues control should be
   a. Debited for $10,000,000.
   b. Credited for $10,000,000.
   c. Debited for $50,000,000.
   d. Credited for $50,000,000.

25. To record the $40,000,000 of budgeted appropriations, Cliff should
   a. Debit estimated expenditures control.
   b. Credit estimated expenditures control.
   c. Debit appropriations control.
   d. Credit appropriations control.

26. The $10,000,000 budgeted excess of revenues over appropriations should be
   a. Debited to budgetary fund balance—unreserved.
   b. Credited to budgetary fund balance—unreserved.
   c. Debited to estimated excess revenues control.
   d. Credited to estimated excess revenues control.

2M88

Items 44 through 50 are based on the following information:

Maple Township uses encumbrance accounting, and formally integrates its budget into the accounting records for its general fund. For the year ending June 30, 1988, the Township Council adopted a budget comprising estimated revenues of $10,000,000, appropriations of $9,000,000, and an estimated transfer of $300,000 to the debt service fund. The following additional information is provided:

- For the month of April 1988, salaries and wages expense of $200,000 was incurred.
- On April 10, 1988, an approved $1,500 purchase order was issued for supplies. These supplies were received on May 1, 1988, and the $1,500 invoice was approved for payment.
- In November 1987, an unexpected state grant of $100,000 was received to finance the purchase of school buses, and an additional grant of $5,000 was received for bus maintenance and operations. Only $60,000 of the capital grant was used in the current year for the purchase of buses, but the entire operating grant of $5,000 was disbursed in the current year. The remaining $40,000 of the capital grant is expected to be expended during the year ending June 30, 1989. Maple's school bus system is appropriately accounted for in the capital projects fund.

44. On adoption of the budget, the journal entry to record the budgetary fund balance should include a
   a. Debit of $700,000.
   b. Credit of $700,000.
   c. Debit of $1,000,000.
   d. Credit of $1,000,000.

45. Budgeted revenues would be recorded by a
   a. Debit to estimated revenues control, $10,000,000.
   b. Debit to estimated revenues receivable, $10,000,000.
   c. Credit to estimated revenues, $10,000,000.
   d. Credit to other financing sources control, $10,000,000.

46. Budgeted appropriations would be recorded by a
   a. Debit to estimated expenditures, $9,300,000.
   b. Credit to appropriations control, $9,300,000.
   c. Debit to estimated expenditures, $9,000,000.
   d. Credit to appropriations control, $9,000,000.

47. What journal entry should be made on April 10, 1988, to record the approved purchase order?

		Debit	*Credit*
a.	Expenditures control	$1,500	
	Encumbrances control		$1,500
b.	Encumbrances control	1,500	
	Expenditures control		1,500
c.	Encumbrances control	1,500	
	Fund balance reserved for encumbrances		1,500
d.	Encumbrances control	1,500	
	Appropriations control		1,500

48. What journal entries should be made on May 1, 1988, upon receipt of the supplies and approval of the invoice?

		Debit	Credit
a.	Encumbrances control	$1,500	
	Appropriations control		$1,500
	Supplies expense	1,500	
	Vouchers payable		1,500
b.	Fund balance reserved for encumbrances	1,500	
	Encumbrances control		1,500
	Expenditures control	1,500	
	Vouchers payable		1,500
c.	Appropriations control	1,500	
	Encumbrances control		1,500
	Expenditures control	1,500	
	Vouchers payable		1,500
d.	Expenditures control	1,500	
	Encumbrances control		1,500
	Supplies expense	1,500	
	Vouchers payable		1,500

49. In connection with the grants for the purchase of school buses and bus maintenance and operations, what amount should be reported as grant revenues for the year ending June 30, 1988?
  a. $ 5,000
  b. $ 60,000
  c. $ 65,000
  d. $100,000

50. What journal entry should be made to record the salaries and wages expense incurred for April?

		Debit	Credit
a.	Salaries and wages expense	$200,000	
	Vouchers payable		$200,000
b.	Appropriations control	200,000	
	Vouchers payable		200,000
c.	Encumbrances control	200,000	
	Vouchers payable		200,000
d.	Expenditures control	200,000	
	Vouchers payable		200,000

B. Types of Funds and Fund Accounts

2M92#27. Lake County received the following proceeds that are legally restricted to expenditure for specified purposes:

Levies on affected property owners to install sidewalks	$500,000
Gasoline taxes to finance road repairs	900,000

What amount should be accounted for in Lake's special revenue funds?
  a. $1,400,000
  b. $ 900,000
  c. $ 500,000
  d. $0

2M92#28. On April 1, 1992, Oak County incurred the following expenditures in issuing long-term bonds:

Issue costs	$400,000
Debt insurance	90,000

When Oak establishes the accounting for operating debt service, what amount should be deferred and amortized over the life of the bonds?
  a. $0
  b. $ 90,000
  c. $400,000
  d. $490,000

2M92#29. At December 31, 1991, the following balances were due from the state government to Clare City's various funds:

Capital projects	$300,000
Trust and agency	100,000
Enterprise	80,000

In Clare's December 31, 1991, combined balance sheet for all fund types and account groups, what amount should be classified under governmental funds?
  a. $100,000
  b. $180,000
  c. $300,000
  d. $480,000

2M92#30. The following transactions were among those reported by Cliff County's water and sewer enterprise fund for 1991:

Proceeds from sale of revenue bonds	$5,000,000
Cash received from customer households	3,000,000
Capital contributed by subdividers	1,000,000

In the water and sewer enterprise fund's statement of cash flows for the year ended December 31, 1991, what amount should be reported as cash flows from capital and related financing activities?
  a. $9,000,000
  b. $8,000,000
  c. $6,000,000
  d. $5,000,000

2M92#31. Gem City's internal service fund received a residual equity transfer of $50,000 cash from the general fund. This $50,000 transfer should be reported in Gem's internal service fund as a credit to
  a. Revenues.
  b. Other financing sources.
  c. Accounts payable.
  d. Contributed capital.

2M92#32. Glen County uses governmental fund accounting and is the administrator of a multiple-jurisdiction deferred compensation plan covering both its own employees and those of other governments participating in the plan. This plan is an eligible deferred compensation plan under the U.S. Internal Revenue Code and Income Tax Regulations. Glen has legal access to the plan's $40,000,000 in assets, comprising $2,000,000 pertaining to Glen and $38,000,000 pertaining to the other participating governments. In Glen's balance sheet, what amount should be reported in an agency fund for plan assets and as a corresponding liability?

a. $0
b. $ 2,000,000
c. $38,000,000
d. $40,000,000

2M92#33. The following are Boa City's fixed assets:

Fixed assets used in proprietary fund activities	$1,000,000
Fixed assets used in governmental-type trust funds	1,800,000
All other fixed assets	9,000,000

What aggregate amount should Boa account for in the general fixed assets account group?

a. $ 9,000,000
b. $10,000,000
c. $10,800,000
d. $11,800,000

2M92#34. The following obligations were among those reported by Fern Village at December 31, 1991:

Vendor financing with a term of 10 months when incurred, in connection with a capital asset acquisition that is not part of a long-term financing plan	$ 150,000
Long-term bonds for financing of capital asset acquisition	3,000,000
Bond anticipation notes due in six months, issued as part of a long-term financing plan for capital purposes	400,000

What aggregate amount should Fern report as general long-term capital debt at December 31, 1991?

a. $3,000,000
b. $3,150,000
c. $3,400,000
d. $3,550,000

2M92#35. The following funds were among those held by State College at December 31, 1991:

Principal specified by the donor as nonexpendable	$500,000
Principal expendable after the year 2000	300,000
Principal designated from current funds	100,000

What amount should State College classify as regular endowment funds?

a. $100,000
b. $300,000
c. $500,000
d. $900,000

2M92#36. Dale City is accumulating financial resources that are legally restricted to payments of general long-term debt principal and interest maturing in future years. At December 31, 1991, $5,000,000 has been accumulated for principal payments and $300,000 has been accumulated for interest payments. These restricted funds should be accounted for in the

	Debt service fund	*General fund*
a.	$0	$5,300,000
b.	$ 300,000	$5,000,000
c.	$5,000,000	$ 300,000
d.	$5,300,000	$0

2M92#37. City University made a discretionary transfer of $100,000 to its library fund. This transfer should be recorded by a debit to

a. Unrestricted current fund balance.
b. Restricted current fund balance.
c. General fund expenditures.
d. Library fund expenditures.

2N90#41. Maple Township issued the following bonds during the year ended June 30, 1990:

Bonds issued for the garbage collection enterprise fund that will service the debt	$500,000
Revenue bonds to be repaid from admission fees collected by the Township zoo enterprise fund	350,000

What amount of these bonds should be accounted for in Maple's general long-term debt account group?

a. $0
b. $350,000
c. $500,000
d. $850,000

2N90#42. On December 31, 1989, Elm Village paid a contractor $4,500,000 for the total cost of a new Village Hall built in 1989 on Village-owned land. Financing for the capital project was provided by a $3,000,000 general obligation bond issue sold at face amount on December 31, 1989, with the remaining $1,500,000 transferred from the general fund. What account and amount should be reported in Elm's 1989 financial statements for the general fund?

a.	Other financing sources control	$4,500,000.
b.	Expenditures control	$4,500,000.
c.	Other financing sources control	$3,000,000.
d.	Other financing uses control	$1,500,000.

2N90#43. During 1989, Spruce City reported the following receipts from self-sustaining activities paid for by users of the services rendered:

Operation of water supply plant	$5,000,000
Operation of bus system	900,000

What amount should be accounted for in Spruce's enterprise funds?

a. $0
b. $ 900,000
c. $5,000,000
d. $5,900,000

2N90#44. Lori Township received a gift of an ambulance having a market value of $180,000. What account in the general fixed assets account group should be debited for this $180,000 gift?

a. None (memorandum entry only).
b. Investment in general fixed assets from gifts.
c. Machinery and equipment.
d. General fund assets.

2N90#45. Through an internal service fund, Wood County operates a centralized data processing center to provide services to Wood's other governmental units. In 1989, this internal service fund billed Wood's parks and recreation fund $75,000 for data processing services. What account should Wood's internal service fund credit to record this $75,000 billing to the parks and recreation fund?

a. Operating revenues control.
b. Interfund exchanges.
c. Intergovernmental transfers.
d. Data processing department expenses.

2N90#47. Kew City received a $15,000,000 federal grant to finance the construction of a center for rehabilitation of drug addicts. The proceeds of this grant should be accounted for in the

a. Special revenue funds.
b. General fund.
c. Capital projects funds.
d. Trust funds.

2N90#48. Lisa County issued $5,000,000 of general obligation bonds at 101 to finance a capital project. The $50,000 premium was to be used for payment of principal and interest. This transaction should be accounted for in the

a. Capital projects funds, debt service funds, and the general long-term debt account group.
b. Capital projects funds and debt service funds only.
c. Debt service funds and the general long-term debt account group only.
d. Debt service funds only.

2N90#49. In 1989, a state government collected income taxes of $8,000,000 for the benefit of one of its cities that imposes an income tax on its residents. The state remitted these collections periodically to the city. The state should account for the $8,000,000 in the

a. General fund.
b. Agency funds.
c. Internal service funds.
d. Special assessment funds.

2N90#52. Cliff Hospital, a voluntary institution, has a pure endowment fund, the income from which is required to be used for library acquisitions. State law and the donor are silent on the accounting treatment for investment gains and losses. In 1989, Cliff sold 1,000 shares of stock from the endowment fund's investment portfolio. The carrying amount of these securities was $50,000. Net proceeds from the sale amounted to $120,000. This transaction should be recorded in the endowment fund as a debit to cash for $120,000 and as credits to

a. Endowment fund principal, $50,000 and endowment fund revenue, $70,000.
b. Endowment fund principal, $50,000 and due to general fund, $70,000.
c. Investments, $50,000 and endowment fund balance, $70,000.
d. Investments, $50,000 and endowment fund revenue, $70,000.

2N90#53. The following financial resources were among those received by Seco City during 1989:

For acquisition of major capital facilities	$6,000,000
To create an expendable trust	2,000,000

With respect to the foregoing resources, what amount should be recorded in special revenue funds?

a. $0
b. $2,000,000
c. $6,000,000
d. $8,000,000

2M90
Items 1 through 6 are based on the following:

Rock County has acquired equipment through a noncancelable lease-purchase agreement dated December 31, 1989. This agreement requires no down payment and the following minimum lease payments:

December 31	*Principal*	*Interest*	*Total*
1990	$50,000	$15,000	$65,000
1991	50,000	10,000	60,000
1992	50,000	5,000	55,000

1. What account should be debited for $150,000 in the general fund at inception of the lease if the equipment is a general fixed asset and Rock does **not** use a capital projects fund?

a. Other financing uses control.
b. Equipment.
c. Expenditures control.
d. Memorandum entry only.

2. What account should be credited for $150,000 in the general fixed assets account group at inception of the lease if the equipment is a general fixed asset?

a. Fund balance from capital lease transactions.
b. Other financing sources control — capital leases.

c. Expenditures control — capital leases.
d. Investment in general fixed assets — capital leases.

3. What journal entry is required for $150,000 in the general long-term debt account group at inception of the lease if the lease payments are to be financed with general government resources?

	Debit	*Credit*
a.	Expenditures control.	Other financing sources control.
b.	Other financing uses control.	Expenditures control.
c.	Amount to be provided for lease payments.	Capital lease payable.
d.	Capital lease payable.	Amount to be provided for lease payments.

4. If the lease payments are required to be made from a debt service fund, what account or accounts should be debited in the debt service fund for the December 31, 1990 lease payment of $65,000?

a. Expenditures control $65,000

b. Other financing sources control $50,000
Expenditures control 15,000

c. Amount to be provided for lease payments $50,000
Expenditures control 15,000

d. Expenditures control $50,000
Amount to be provided for lease payments 15,000

5. If the equipment is used in enterprise fund operations and the lease payments are to be financed with enterprise fund revenues, what account should be debited for $150,000 in the enterprise fund at inception of the lease?
a. Expenses control.
b. Expenditures control.
c. Other financing sources control.
d. Equipment.

6. If the equipment is used in internal service fund operations and the lease payments are financed with internal service fund revenues, what account or accounts should be debited in the internal service fund for the December 31, 1990 lease payment of $65,000?

a. Expenditures control $65,000

b. Expenses control $65,000

c. Capital lease payable $50,000
Expenses control 15,000

d. Expenditures control $50,000
Expenses control 15,000

2M90
Items 7 and 8 are based on the following:

Elm City contributes to and administers a single-employer defined benefit pension plan on behalf of its covered employees. The plan is accounted for in a pension trust fund. Actuarially determined employer contribution requirements and contributions actually made for the past three years, along with the percentage of annual covered payroll, were as follows:

	Contribution made		*Actuarial requirement*	
	Amount	*Percent*	*Amount*	*Percent*
1989	$11,000	26	$11,000	26
1988	5,000	12	10,000	24
1987	None	None	8,000	20

7. What account should be credited in the pension trust fund to record the 1989 employer contribution of $11,000?
a. Revenues control.
b. Other financing sources control.
c. Due from special revenue fund.
d. Pension benefit obligation.

8. To record the 1989 pension contribution of $11,000, what debit is required in the governmental-type fund used in connection with employer pension contributions?
a. Other financing uses control.
b. Expenditures control.
c. Expenses control.
d. Due to pension trust fund.

2M90#10. Grove Township issued $50,000 of bond anticipation notes at face amount in 1989 and placed the proceeds into its capital projects fund. All legal steps were taken to refinance the notes, but Grove was unable to consummate refinancing. In the capital projects fund, what account should be credited to record the $50,000 proceeds?
a. Other financing sources control.
b. Revenues control.
c. Deferred revenues.
d. Bond anticipation notes payable.

2M90
Items 14 and 15 are based on the following:

In 1979, Community Helpers, a voluntary health and welfare organization, received a bequest of a $100,000 certificate of deposit maturing in 1989. The testator's only stipulations were that this certificate be held until maturity and that the interest revenue be used to finance salaries for a preschool program. Interest revenue for 1989 was $8,000. When the certificate was redeemed, the board of trustees adopted a formal resolution designating $20,000 of the proceeds for the future purchase of equipment for the preschool program.

14. In regard to the certificate of deposit, what should be reported in the endowment fund column of the 1989 statement of support, revenue, and expenses and changes in fund balances?
   a. Legacies and bequests, $100,000.
   b. Direct reduction in fund balance for transfer to current unrestricted fund, $100,000.
   c. Transfer to land, building, and equipment fund, $20,000.
   d. Revenues control, $100,000.

15. What should be reported in the current unrestricted funds column of the 1989 statement of support, revenue, and expenses and changes in fund balances?
   a. Investment income, $8,000.
   b. Direct reduction of fund balance for transfer to land, building, and equipment fund, $20,000.
   c. Direct addition to fund balance for transfer from endowment fund, $100,000.
   d. Public support, $108,000.

2M89#28. On December 31, 1988, Park Township paid a contractor $4,000,000 for the total cost of a new police building built in 1988. Financing was by means of a $3,000,000 general obligation bond issue sold at face amount on December 31, 1988, with the remaining $1,000,000 transferred from the general fund. What amount should Park record as revenues in the capital projects fund in connection with the bond issue proceeds and the transfer?
   a. $0
   b. $1,000,000
   c. $3,000,000
   d. $4,000,000

2M89#39. The following fund types used by Green Township had total assets at June 30, 1989 as follows:

Agency funds	$ 300,000
Debt service funds	1,000,000

Total fiduciary fund assets amount to
   a. $0
   b. $ 300,000
   c. $1,000,000
   d. $1,300,000

2N88
Items 41 and 42* are based on the following:

On December 31, 1987, Vane City paid a contractor $3,000,000 for the total cost of a new municipal annex built in 1987 on city-owned land. Financing was provided by a $2,000,000 general obligation bond issue sold at face amount on December 31, 1987, with the remaining $1,000,000 transferred from the general fund.

42. What accounts and amounts should be reported in Vane's 1987 financial statements for the capital projects fund?
   a. Other financing sources control, $2,000,000; General long-term debt, $2,000,000.
   b. Revenues control, $2,000,000; Expenditures control, $2,000,000.
   c. Other financing sources control, $3,000,000; Expenditures control, $3,000,000.
   d. Revenues control, $3,000,000; Expenditures control, $3,000,000.

2N88#43. The following information for the year ended June 30, 1988 pertains to a proprietary fund established by Burwood Village in connection with Burwood's public parking facilities:

Receipts from users of parking facilities	$400,000
Expenditures	
Parking meters	210,000
Salaries and other cash expenses	90,000
Depreciation of parking meters	70,000

For the year ended June 30, 1988, this proprietary fund should report net income of
   a. $0
   b. $ 30,000
   c. $100,000
   d. $240,000

2N88#44. The following proceeds received by Grove City in 1987 are legally restricted to expenditure for specified purposes:

Donation by a benefactor mandated to an expendable trust fund to provide meals for the needy	$300,000
Sales taxes to finance the maintenance of tourist facilities in the shopping district	900,000

What amount should be accounted for in Grove's special revenue funds?
   a. $0
   b. $ 300,000
   c. $ 900,000
   d. $1,200,000

2N88#45. In connection with Albury Township's long-term debt, the following cash accumulations are available to cover payment of principal and interest on

Bonds for financing of water treatment plant construction	$1,000,000
General long-term obligations	400,000

*The item omitted can be found in other Content Specification Groups.

The amount of these cash accumulations that should be accounted for in Albury's debt service funds is

a. $0
b. $ 400,000
c. $1,000,000
d. $1,400,000

2N88#46. During its fiscal year ended June 30, 1988, Lake County financed the following projects by special assessments:

Capital improvements	$2,000,000
Service-type projects	800,000

For financial reporting purposes, what amount should appear in special assessment funds?

a. $2,800,000
b. $2,000,000
c. $ 800,000
d. $0

2N88#47. Hull City has established a separate internal service (self-insurance) fund to pay claims and judgments of all of Hull's funds. In 1987, payments to the insurer fund amounted to $500,000, while the actuarially determined amount was $400,000. The payments to the insurer fund should be accounted for as

	An operating transfer of	*A residual equity transfer of*
a.	$0	$0
b.	$100,000	$400,000
c.	$400,000	$100,000
d.	$500,000	$0

2N88#48. The following fund types used by Cliff City had total assets at December 31, 1987, as follows:

Special revenue funds	$100,000
Agency funds	150,000
Trust funds	200,000

Total fiduciary fund assets amounted to

a. $200,000
b. $300,000
c. $350,000
d. $450,000

2N88#49. The following information pertains to a computer that Pine Township leased from Karl Supply Co. on July 1, 1988, for general township use:

Karl's cost	$5,000
Fair value at July 1, 1988	$5,000
Estimated economic life	5 years
Fixed noncancelable term	30 months
Rental at beginning of each month	$135
Guaranteed residual value	$2,000
Present value of minimum lease payments at July 1, 1988, using Pine's incremental borrowing rate of 10.5%	$5,120
Karl's implicit interest rate of 12.04%	$5,000

On July 1, 1988, what amount should Pine capitalize in its general fixed assets account group for this leased computer?

a. $0
b. $3,000
c. $5,000
d. $5,120

2N88#51. Lane Foundation received a nonexpendable endowment of $500,000 in 1986 from Gant Enterprises. The endowment assets were invested in publicly traded securities. Gant did not specify how gains and losses from dispositions of endowment assets were to be treated. No restrictions were placed on the use of dividends received and interest earned on fund resources. In 1987, Lane realized gains of $50,000 on sales of fund investments, and received total interest and dividends of $40,000 on fund securities. The amount of these capital gains, interest, and dividends available for expenditure by Lane's unrestricted current fund is

a. $0
b. $40,000
c. $50,000
d. $90,000

2N88#52. In 1987, the Board of Trustees of Burr Foundation designated $100,000 from its current funds for college scholarships. Also in 1987, the foundation received a bequest of $200,000 from an estate of a benefactor who specified that the bequest was to be used for hiring teachers to tutor handicapped students. What amount should be accounted for as current restricted funds?

a. $0
b. $100,000
c. $200,000
d. $300,000

2M88#41. The following items were among Wood Township's expenditures from the general fund during the year ended June 30, 1987:

Furniture for Township Hall	$10,000
Minicomputer for tax collector's office	15,000

The amount that should be classified as fixed assets in Wood's general fund balance sheet at June 30, 1987 is

a. $25,000
b. $15,000
c. $10,000
d. $0

2M88#43. Grove County collects property taxes levied within its boundaries and receives a 1% fee for administering these collections on behalf of the municipalities located in the county. In 1987, Grove collected $1,000,000 for its municipalities and remitted $990,000 to them after deducting fees of $10,000. In the initial recording of the 1% fee, Grove's agency fund should credit

a. Fund balance — agency fund, $10,000.
b. Fees earned — agency fund, $10,000.
c. Due to Grove County general fund, $10,000.
d. Revenues control, $10,000.

C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

2N90
Items 58 through 60 are based on the following:

United Together, a labor union, had the following receipts and expenses for the year ended December 31, 1989:

Receipts:	
Per capita dues	$680,000
Initiation fees	90,000
Sales of organizational supplies	60,000
Nonexpendable gift restricted by donor for loan purposes for 10 years	30,000
Nonexpendable gift restricted by donor for loan purposes in perpetuity	25,000
Expenses:	
Labor negotiations	500,000
Fund-raising	100,000
Membership development	50,000
Administrative and general	200,000

Additional information:

The union's constitution provides that 10% of the per capita dues are designated for the Strike Insurance Fund to be distributed for strike relief at the discretion of the union's executive board.

58. In United Together's statement of activity for the year ended December 31, 1989, what amount should be reported under the classification of revenue for both undesignated and designated funds?

a. $740,000
b. $762,000
c. $770,000
d. $830,000

59. In United Together's statement of activity for the year ended December 31, 1989, what amount should be reported under the classification of program services?

a. $850,000
b. $600,000
c. $550,000
d. $500,000

60. In United Together's statement of activity for the year ended December 31, 1989, what amount should be reported under the classification of capital additions?

a. $55,000
b. $30,000
c. $25,000
d. $0

2M90
Item 9 is based on the following:

Elm City contributes to and administers a single-employer defined benefit pension plan on behalf of its covered employees. The plan is accounted for in a pension trust fund. Actuarially determined employer contribution requirements and contributions actually made for the past three years, along with the percentage of annual covered payroll, were as follows:

	Contribution made		*Actuarial requirement*	
	Amount	*Percent*	*Amount*	*Percent*
1989	$11,000	26	$11,000	26
1988	5,000	12	10,000	24
1987	None	None	8,000	20

9. In the notes to Elm's 1989 financial statements, employer contributions expressed as percentages of annual covered payroll should be shown to the extent available for a minimum of

a. 1 year.
b. 2 years.
c. 3 years.
d. 12 years.

2M90
Item 16 is based on the following:

In 1979, Community Helpers, a voluntary health and welfare organization, received a bequest of a $100,000 certificate of deposit maturing in 1989. The testator's only stipulations were that this certificate be held until maturity and that the interest revenue be used to finance salaries for a preschool program. Interest revenue for 1989 was $8,000. When the certificate was redeemed, the board of trustees adopted a formal resolution designating $20,000 of the proceeds for the future purchase of equipment for the preschool program.

16. What should be reported in the 1989 year-end current unrestricted funds balance sheet?

a. Fund balance designated for preschool program, $28,000;
Undesignated fund balance, $80,000.
b. Fund balance designated for purchase of equipment, $20,000;
Undesignated fund balance, $80,000.
c. Fund balance designated for preschool program salaries, $8,000;
Undesignated fund balance, $80,000.
d. Undesignated fund balance, $72,000.

2M90
Item 19 is based on the following:

Metro General is a municipally-owned and operated hospital and a component unit of Metro City. In 1989, the hospital received $7,000 in unrestricted gifts and $4,000 in unrestricted bequests. The hospital has $800,000 in long-term debt and $1,200,000 in fixed assets.

The hospital has transferred certain resources to a hospital guild. Substantially all of the guild's resources are held for the benefit of the hospital. The hospital controls the guild through contracts that provide it with the authority to direct the guild's activities, management, and policies. The hospital has also assigned certain of its functions to a hospital auxiliary, which operates primarily for the benefit of the hospital. The hospital does **not** have control over the auxiliary. The financial statements of the guild and the auxiliary are **not** consolidated with the hospital's financial statements. The guild and the auxiliary have total assets of $20,000 and $30,000, respectively.

Before the hospital's financial statements were combined with those of the city, the city's statements included data on one special revenue fund and one enterprise fund. The city's statements showed $100,000 in enterprise fund long-term debt, $500,000 in enterprise fund fixed assets, $1,000,000 in general long-term debt, and $6,000,000 in general fixed assets.

19. In the hospital's notes to financial statements, total assets of hospital-related organizations required to be disclosed amount to
   a. $0
   b. $20,000
   c. $30,000
   d. $50,000

D. Various Types of Not-for-Profit and Governmental Organizations

2M92#38. Community College had the following encumbrances at December 31, 1991:

Outstanding purchase orders	$12,000
Commitments for services not received	50,000

What amount of these encumbrances should be reported as liabilities in Community's balance sheet at December 31, 1991?
   a. $62,000
   b. $50,000
   c. $12,000
   d. $0

2M92#40. Environs, a community foundation, incurred $10,000 in management and general expenses during 1991. In Environs' statement of revenue, expense, and changes in fund balance for the year ended December 31, 1991, the $10,000 should be reported as
   a. A direct reduction of fund balance.
   b. Part of supporting services.
   c. Part of program services.
   d. A contra account to offset revenue and support.

2M90#11. In July 1988, Ross donated $200,000 cash to a church with the stipulation that the revenue generated from this gift be paid to Ross during Ross' lifetime. The conditions of this donation are that, after Ross dies, the principal may be used by the church for any purpose voted on by the church elders. The church received interest of $16,000 on the $200,000 for the year ended June 30, 1989, and the interest was remitted to Ross. In the church's June 30, 1989 annual financial statements.
   a. $200,000 should be reported as deferred support in the balance sheet.
   b. $184,000 should be reported under support and revenue in the activity statement.
   c. $16,000 should be reported under support and revenue in the activity statement.
   d. The gift and its terms should be disclosed only in notes to the financial statements.

2M90#13. Lema Fund, a voluntary welfare organization funded by contributions from the general public, received unrestricted pledges of $200,000 during 1989. It was estimated that 10% of these pledges would be uncollectible. By the end of 1989, $130,000 of the pledges had been collected. It was expected that $50,000 more would be collected in 1990 and that the balance of $20,000 would be written off as uncollectible. What amount should Lema include under public support in 1989 for net contributions?
   a. $200,000
   b. $180,000
   c. $150,000
   d. $130,000

2M90
Items 17 through 20* are based on the following:

Metro General is a municipally-owned and operated hospital and a component unit of Metro City. In 1989, the hospital received $7,000 in unrestricted gifts and $4,000 in unrestricted bequests. The hospital has $800,000 in long-term debt and $1,200,000 in fixed assets.

The hospital has transferred certain resources to a hospital guild. Substantially all of the guild's resources are held for the benefit of the hospital. The hospital controls the guild through contracts that provide it with the authority to direct the guild's activities, management, and policies. The hospital has also assigned certain of its functions to a hospital auxiliary, which operates primarily for the benefit of the hospital. The hospital does **not** have control over the auxiliary. The financial statements of the guild and the auxiliary are **not** consolidated with the hospital's financial state-

*The item omitted can be found in other Content Specification Groups.

ments. The guild and the auxiliary have total assets of $20,000 and $30,000, respectively.

Before the hospital's financial statements were combined with those of the city, the city's statements included data on one special revenue fund and one enterprise fund. The city's statements showed $100,000 in enterprise fund long-term debt, $500,000 in enterprise fund fixed assets, $1,000,000 in general long-term debt, and $6,000,000 in general fixed assets.

17. What account or accounts should be credited for the $7,000 of unrestricted gifts and the $4,000 of unrestricted bequests?

a.	Operating revenue	$11,000
b.	Nonoperating revenue	$11,000
c.	Operating revenue Nonoperating revenue	$7,000 4,000
d.	Nonoperating revenue Operating revenue	$7,000 4,000

18. The hospital's long-term debt should be reported in the city's combined balance sheet as
   a. Part of $900,000 enterprise fund type long-term debt in the enterprise fund type column.
   b. An $800,000 contra amount against fixed assets.
   c. Part of the $1,800,000 general long-term debt account group.
   d. A separate "discrete presentation" of $800,000 in the hospital column.

20. The hospital's fixed assets should be reported in the city's combined balance sheet as
   a. Hospital fixed assets of $1,200,000 in a separate "discrete presentation" hospital column.
   b. Special revenue fund type fixed assets of $1,200,000 in the general fixed assets account group column.
   c. Part of $1,700,000 enterprise fund type fixed assets in the enterprise fund type column.
   d. Part of $7,200,000 general fixed assets in the general fixed assets account group.

2M89

Items 29 through 31 are based on the following information pertaining to Lori Hospital for the year ended May 31, 1989:

In March 1989, a $300,000 unrestricted bequest and a $500,000 pure endowment grant were received. In April 1989, a bank notified Lori that the bank received $10,000 to be held in permanent trust by the bank. Lori is to receive the income from this donation.

29. Lori should record the $300,000 unrestricted bequest as
   a. Nonoperating revenue.
   b. Other operating revenue.
   c. A direct credit to the fund balance.
   d. A credit to operating expenses.

30. The $500,000 pure endowment grant
   a. May be expended by the governing board only to the extent of the principal since the income from this fund must be accumulated.
   b. Should be reported as nonoperating revenue when the full amount of principal is expended.
   c. Should be recorded as a memorandum entry only.
   d. Should be accounted for as restricted funds upon receipt.

31. The $10,000 donation being held by the bank in permanent trust should be
   a. Recorded in Lori's restricted endowment fund.
   b. Recorded by Lori as nonoperating revenue.
   c. Recorded by Lori as other operating revenue.
   d. Disclosed in notes to Lori's financial statements.

2M89

Items 32 through 34* are based on the following information pertaining to Cabal University as of June 30, 1989 and for the year then ended:

Unrestricted current funds comprised $7,500,000 of assets and $4,500,000 of liabilities (including deferred revenues of $150,000). Among the receipts recorded during the year were unrestricted gifts of $550,000 and restricted grants totaling $330,000, of which $220,000 was expended during the year for current operations and $110,000 remained unexpended at the close of the year.

Volunteers from the surrounding communities regularly contribute their services to Cabal and are paid nominal amounts to cover their travel costs. During the year, the total amount paid to these volunteers aggregated $18,000. The gross value of services performed by them, determined by reference to equivalent wages available in that area for similar services, amounted to $200,000.

32. At June 30, 1989, the fund balance of Cabal's unrestricted current funds was
   a. $7,500,000
   b. $3,150,000
   c. $3,000,000
   d. $2,850,000

33. For the year ended June 30, 1989, what amount should be included in Cabal's current funds revenues for the unrestricted gifts and restricted grants?
   a. $550,000
   b. $660,000
   c. $770,000
   d. $880,000

*The item omitted can be found in other Content Specification Groups.

2M89

Items 36 through 38 are based on the following information pertaining to Rega Foundation, a voluntary welfare organization funded by contributions from the general public:

During 1988, unrestricted pledges of $600,000 were received, of which it was estimated that $72,000 would be uncollectible. By the end of 1988, $480,000 of the pledges had been collected, and it was expected that an additional $48,000 of these pledges would be collected in 1989, with the balance to be written off as uncollectible. Donors did **not** specify any periods during which the donations were to be used.

Also during 1988, Rega sold a computer for $18,000. Its cost was $21,000 and its book value was $15,000. Rega made the correct entry to record the gain on sale.

36. What amount should Rega include under public support in 1988 for net contributions?
   a. $480,000
   b. $528,000
   c. $531,000
   d. $600,000

37. In addition to the entry recording the gain on sale of the computer, the other accounts that Rega should debit and credit in connection with this sale are

	Debit	*Credit*
a.	Current unrestricted funds	Fund balance—undesignated
b.	Excess revenues control	Sale of equipment
c.	Fund balance—unexpended	Fund balance—expended
d.	Fund balance—expended	Fund balance—unexpended

38. The amount that should be debited and credited for the additional entry in connection with the sale of the computer is
   a. $ 3,000
   b. $15,000
   c. $18,000
   d. $21,000

2N88#53. The following information pertains to interest received by Beech University from endowment fund investments for the year ended June 30, 1988:

	Received	*Expended for current operations*
Unrestricted	$300,000	$100,000
Restricted	500,000	75,000

What amount should be credited to endowment income for the year ended June 30, 1988?
   a. $800,000
   b. $375,000
   c. $175,000
   d. $100,000

2N88#54. On July 31, 1988, Sabio College showed the following amounts to be used for

Renewal and replacement of college properties	$200,000
Retirement of indebtedness on college properties	300,000
Purchase of physical properties for college purposes, but unexpended at 7/31/88	400,000

What total amount should be included in Sabio's plant funds at July 31, 1988?
   a. $900,000
   b. $600,000
   c. $400,000
   d. $200,000

2N88#56. Under Cura Hospital's established rate structure, patient service revenues of $9,000,000 would have been earned for the year ended December 31, 1987. However, only $6,750,000 was collected because of charity allowances of $1,500,000 and discounts of $750,000 to third-party payors. For the year ended December 31, 1987, what amount should Cura record as patient service revenues?
   a. $6,750,000
   b. $7,500,000
   c. $8,250,000
   d. $9,000,000

2N88#57. An organization of high school seniors performs services for patients at Leer Hospital. These students are volunteers and perform services that the hospital would not otherwise provide, such as wheeling patients in the park and reading to patients. Leer has no employer-employee relationship with these volunteers, who donated 5,000 hours of service to Leer in 1987. At the minimum wage rate, these services would amount to $18,750, while it is estimated that the fair value of these services was $25,000. In Leer's 1987 statement of revenues and expenses, what amount should be reported as nonoperating revenue?
   a. $25,000
   b. $18,750
   c. $ 6,250
   d. $0

2N88#58. In June 1988, Park Hospital purchased medicines from Jove Pharmaceutical Co. at a cost of $2,000. However, Jove notified Park that the invoice was being canceled, and that the medicines were being donated to Park. Park should record this donation of medicines as
   a. A memorandum entry only.
   b. Other operating revenue of $2,000.
   c. A $2,000 credit to operating expenses.
   d. A $2,000 credit to nonoperating expenses.

2N88#59. In 1987, a nonprofit trade association enrolled five new member companies, each of which was obligated to pay nonrefundable initiation fees of $1,000.

These fees were receivable by the association in 1987. Three of the new members paid the initiation fees in 1987, and the other two new members paid their initiation fees in 1988. Annual dues (excluding initiation fees) received by the association from all of its members have always covered the organization's costs of services provided to its members. It can be reasonably expected that future dues will cover all costs of the organization's future services to members. Average membership duration is 10 years because of mergers, attrition, and economic factors. What amount of initiation fees from these five new members should the association recognize as revenue in 1987?

a. $5,000
b. $3,000
c. $ 500
d. $0

2N88#60. On January 2, 1987, a nonprofit botanical society received a gift of an exhaustible fixed asset with an estimated useful life of 10 years and no salvage value. The donor's cost of this asset was $20,000, and its fair market value at the date of the gift was $30,000. What amount of depreciation of this asset should the society recognize in its 1987 financial statements?

a. $3,000
b. $2,500
c. $2,000
d. $0

2M88#51. On March 1, 1988, Allan Rowe established a $100,000 endowment fund, the income from which is to be paid to Elm Hospital for general operating purposes. Elm does not control the fund's principal. Rowe appointed West National Bank as trustee of this fund. What journal entry is required by Elm to record the establishment of the endowment?

	Debit	*Credit*
a. Cash	$100,000	
Nonexpendable endowment fund		$100,000
b. Cash	100,000	
Endowment fund balance		100,000
c. Nonexpendable endowment fund	100,000	
Endowment fund balance		100,000
d. Memorandum entry only	—	—

2M88#52. In 1988, Wells Hospital received an unrestricted bequest of common stock with a fair market value of $50,000 on the date of receipt of the stock. The testator had paid $20,000 for this stock in 1986. Wells should record this bequest as

a. Nonoperating revenue of $50,000.
b. Nonoperating revenue of $30,000.
c. Nonoperating revenue of $20,000.
d. A memorandum entry only.

2M88#53. Cedar Hospital has a marketable equity securities portfolio that is appropriately included in noncurrent assets in unrestricted funds. The portfolio has an aggregate cost of $300,000. It had an aggregate fair market value of $250,000 at the end of 1987 and $290,000 at the end of 1986. If the portfolio was properly reported in the balance sheet at the end of 1986, the change in the valuation allowance at the end of 1987 should be

a. $0.
b. A decrease of $40,000.
c. An increase of $40,000.
d. An increase of $50,000.

2M88#54. Ross Hospital's accounting records disclosed the following information:

• Net resources invested in plant assets	$10,000,000
• Board-designated funds	2,000,000

What amount should be included as part of unrestricted funds?

a. $12,000,000
b. $10,000,000
c. $ 2,000,000
d. $0

2M88#56. The following expenditures were among those incurred by a nonprofit botanical society during 1987:

Printing of annual report	$10,000
Unsolicited merchandise sent to encourage contributions	20,000

What amount should be classified as fund-raising costs in the society's activity statement?

a. $0
b. $10,000
c. $20,000
d. $30,000

2M88#57. Unity Fund is a voluntary welfare organization funded by contributions from the general public. During 1987, unrestricted pledges of $100,000 were received, half of which were payable in 1987, with the other half payable in 1988 for use in 1988. It was estimated that 20% of these pledges would be uncollectible. With respect to the pledges, the amount that should be reported for 1987 as net contributions, under public support, is

a. $100,000
b. $ 80,000
c. $ 50,000
d. $ 40,000

2M88#58. For the 1987 summer session, Selva University assessed its students $300,000 for tuition and fees. However, the net amount realized was only $290,000 because of the following reductions:

Tuition remissions granted to faculty members' families	$3,000
Class cancellation refunds	7,000

How much unrestricted current funds revenues from tuition and fees should Selva report for the period?

a. $290,000
b. $293,000
c. $297,000
d. $300,000

2M88#59. The following information was available from Forest College's accounting records for its current funds for the year ended March 31, 1988:

Restricted gifts received	
Expended	$100,000
Not expended	300,000
Unrestricted gifts received	
Expended	600,000
Not expended	75,000

What amount should be included in current funds revenues for the year ended March 31, 1988?

a. $ 600,000
b. $ 700,000
c. $ 775,000
d. $1,000,000

2M88#60. The following expenditures were among those incurred by Alma University during 1987:

Administrative data processing	$ 50,000
Scholarships and fellowships	100,000
Operation and maintenance of physical plant	200,000

The amount to be included in the functional classification "Institutional Support" expenditures account is

a. $ 50,000
b. $150,000
c. $250,000
d. $350,000

IX. Federal Taxation — Individuals, Estates, and Trusts

A. Inclusions for Gross Income and Adjusted Gross Income

2N91
Items 28 through 36* are based on the following:

Hall, a divorced person and custodian of her 12-year old child, filed her 1990 federal income tax return as head of a household. She submitted the following information to the CPA who prepared her 1990 return:

- The divorce agreement, executed in 1983, provides for Hall to receive $3,000 per month, of which $600 is designated as child support. After the child reaches 18, the monthly payments are to be reduced to $2,400 and are to continue until remarriage or death. However, for the year 1990, Hall received a total of only $5,000 from her former husband. Hall paid an attorney $2,000 in 1990 in a suit to collect the alimony owed.
- In June 1990, Hall's mother gifted her 100 shares of a listed stock. The donor's basis for this stock, which she bought in 1970, was $4,000, and market value on the date of the gift was $3,000. Hall sold this stock in July 1990 for $3,500. The donor paid no gift tax.
- During 1990, Hall spent a total of $1,000 for state lottery tickets. Her lottery winnings in 1990 totaled $200.
- Hall earned a salary of $25,000 in 1990. Hall was not covered by any type of retirement plan, but contributed $2,000 to an IRA in 1990.
- In 1990, Hall sold an antique that she bought in 1980 to display in her home. Hall paid $800 for the antique and sold it for $1,400, using the proceeds to pay a court-ordered judgment.
- Hall paid the following expenses in 1990 pertaining to the home that she owns: realty taxes, $3,400; mortgage interest, $7,000; casualty insurance, $490; assessment by city for construction of a sewer system, $910; interest of $1,000 on a personal, unsecured bank loan, the proceeds of which were used for home improvements. Hall does not rent out any portion of the home.

28. What amount should be reported in Hall's 1990 return as alimony income?

a. $36,000
b. $28,800
c. $ 5,000
d. $0

30. What was Hall's reportable gain or loss in 1990 on the sale of the 100 shares of stock gifted to her?

a. $0.
b. $ 500 gain.
c. $ 500 loss.
d. $1,000 loss.

*The items omitted can be found in other Content Specification Groups.

31. Hall's lottery transactions should be reported as follows:

	Other income on page 1	Schedule A—Itemized Deductions: Other Miscellaneous Deductions — Subject to 2% AGI floor	Not subject to 2% AGI floor
a.	$0	$0	$0
b.	$200	$0	$200
c.	$200	$200	$0
d.	$200	$0	$0

2M91#21. For a cash basis taxpayer, gain or loss on a year-end sale of listed stock arises on the
a. Trade date.
b. Settlement date.
c. Date of receipt of cash proceeds.
d. Date of delivery of stock certificate.

2M91#22. Cobb, an unmarried individual, had an adjusted gross income of $200,000 in 1990 before any IRA deduction, taxable social security benefits, or passive activity losses. Cobb incurred a loss of $30,000 in 1990 from rental real estate in which he actively participated. What amount of loss attributable to this rental real estate can be used in 1990 as an offset against income from nonpassive sources?
a. $0
b. $12,500
c. $25,000
d. $30,000

2M91#23. In a "like-kind" exchange of an investment asset for a similar asset that will also be held as an investment, no taxable gain or loss will be recognized on the transaction if both assets consist of
a. Convertible debentures.
b. Convertible preferred stock.
c. Partnership interests.
d. Rental real estate located in different states.

2M91#24. Lee, an attorney, uses the cash receipts and disbursements method of reporting. In 1990, a client gave Lee 500 shares of a listed corporation's stock in full satisfaction of a $10,000 legal fee the client owed to Lee. This stock had a fair market value of $8,000 on the date it was given to Lee. The client's basis for this stock was $6,000. Lee sold the stock for cash in January 1991. In Lee's 1990 income tax return, what amount of income should be reported in connection with the receipt of the stock?
a. $10,000
b. $ 8,000
c. $ 6,000
d. $0

2M91#28. Clark bought Series EE U.S. Savings Bonds after 1989. Redemption proceeds will be used for payment of college tuition for Clark's dependent child. One of the conditions that must be met for tax exemption of accumulated interest on these bonds is that the
a. Purchaser of the bonds must be the sole owner of the bonds (or joint owner with his or her spouse).
b. Bonds must be bought by a parent (or both parents) and put in the name of the dependent child.
c. Bonds must be bought by the owner of the bonds before the owner reaches the age of 24.
d. Bonds must be transferred to the college for redemption by the college rather than by the owner of the bonds.

2N90#25. Ed and Ann Ross were divorced in January 1989. In accordance with the divorce decree, Ed transferred the title in their home to Ann in 1989. The home, which had a fair market value of $150,000, was subject to a $50,000 mortgage that had 20 more years to run. Monthly mortgage payments amount to $1,000. Under the terms of settlement, Ed is obligated to make the mortgage payments on the home for the full remaining 20-year term of the indebtedness, regardless of how long Ann lives. Ed made 12 mortgage payments in 1989. What amount is taxable as alimony in Ann's 1989 return?
a. $0
b. $ 12,000
c. $100,000
d. $112,000

2N90#26. Dahl Corp. was organized and commenced operations in 1930. At December 31, 1989, Dahl had accumulated earnings and profits of $9,000 before dividend declaration and distribution. On December 31, 1989, Dahl distributed cash of $9,000 and a vacant parcel of land to Green, Dahl's only stockholder. At the date of distribution, the land had a basis of $5,000 and a fair market value of $40,000. What was Green's taxable dividend income in 1989 from these distributions?
a. $ 9,000
b. $14,000
c. $44,000
d. $49,000

2N90#27. Don Wolf became a general partner in Gata Associates on January 1, 1989 with a 5% interest in Gata's profits, losses, and capital. Gata is a distributor of auto parts. Wolf does not materially participate in the partnership business. For the year ended December 31, 1989, Gata had an operating loss of $100,000. In addition, Gata earned interest of $20,000 on a temporary investment. Gata has kept the principal temporarily invested while awaiting delivery of equipment that is presently on order. The principal will be used to pay for this equipment. Wolf's passive loss for 1989 is
a. $0
b. $4,000
c. $5,000
d. $6,000

2M89

Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — $34,000.

The Hoyts itemized their deductions.

Among the Hoyts' cash receipts during 1988 were the following:

$1,000 dividends from taxable domestic corporations on stocks held in Sam's name.
$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for $9,000. The Hoyts had **no** other capital gains or losses in the current or prior years.
$6,000 first installment on a $75,000 life insurance policy payable to Ann in annual installments of $6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts' cash expenditures during 1988 were the following:

$2,000 transportation expenses required under the terms of Sam's employment contract were paid by Sam, an outside salesman. No reimbursement was received.
$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.
$800 appraisal fee to determine amount of fire loss.
$3,000 real estate tax on residence; $400 state and city sales taxes; $900 state income tax.
$100 contribution to a recognized political party.

44. What was the taxable amount of dividends on Hoyts' 1988 return?
  a. $1,000
  b. $ 900
  c. $ 800
  d. $ 700

45. What was the allowable amount of long-term capital loss that the Hoyts could offset against ordinary income on their 1988 return?
  a. $0
  b. $2,500
  c. $3,000
  d. $5,000

*The items omitted can be found in other Content Specification Groups.

2M89#54. With regard to the passive loss rules involving rental real estate activities, which one of the following statements is correct?
  a. The term "passive activity" includes any rental activity without regard as to whether or not the taxpayer materially participates in the activity.
  b. Gross investment income from interest and dividends **not** derived in the ordinary course of a trade or business is treated as passive activity income that can be offset by passive rental activity losses when the "active participation" requirement is **not** met.
  c. Passive rental activity losses may be deducted only against passive income, but passive rental activity credits may be used against tax attributable to nonpassive activities.
  d. The passive activity rules do **not** apply to taxpayers whose adjusted gross income is $300,000 or less.

2N88#2. Smith, a retired corporate executive, earned consulting fees of $8,000 and director's fees of $2,000 in 1987. Smith's gross income from self-employment in 1987 was
  a. $0
  b. $ 2,000
  c. $ 8,000
  d. $10,000

2N88#3. Pierre, a headwaiter, received tips totaling $2,000 in December 1987. On January 5, 1988, Pierre reported this tip income to his employer in the required written statement. At what amount, and in which year, should this tip income be included in Pierre's gross income?
  a. $2,000 in 1987.
  b. $2,000 in 1988.
  c. $1,000 in 1987, and $1,000 in 1988.
  d. $ 167 in 1987, and $1,833 in 1988.

2N88#5. If an individual taxpayer's passive losses and credits relating to rental real estate activities cannot be used in the current year, then they may be carried
  a. Back three years, but they cannot be carried forward.
  b. Forward up to a maximum period of 15 years, but they cannot be carried back.
  c. Back three years or forward up to 15 years, at the taxpayer's election.
  d. Forward indefinitely or until the property is disposed of in a taxable transaction.

2N88#6. In 1987, Ben Loy and his wife, Ann, received dividends of $500 and $25, respectively, from taxable domestic corporations. What amount of these dividends could be excluded from the Loys' taxable income on their 1987 joint return?
  a. $0
  b. $125
  c. $200
  d. $225

2N88#7. With regard to the alimony deduction in connection with a 1988 divorce, which one of the following statements is correct?

a. Alimony is deductible by the payor spouse, and includible by the payee spouse, to the extent that payment is contingent on the status of the divorced couple's children.
b. The divorced couple may be members of the same household at the time alimony is paid, provided that the persons do not live as husband and wife.
c. Alimony payments must terminate on the death of the payee spouse.
d. Alimony may be paid either in cash or in property.

2N88#8. A 1988 capital loss incurred by a married couple filing a joint return

a. Will be allowed only to the extent of capital gains.
b. Will be allowed to the extent of capital gains, plus up to $3,000 of ordinary income.
c. May be carried forward up to a maximum of five years.
d. Is **not** an allowable loss.

2N88#9. In 1988, Joan accepted and received a $10,000 award for outstanding civic achievement. Joan was selected without any action on her part, and no future services are expected of her as a condition of receiving the award. What amount should Joan include in her 1988 adjusted gross income in connection with this award?

a. $0
b. $ 4,000
c. $ 5,000
d. $10,000

2M88#1. John Budd is single, with no dependents. During 1987, John received wages of $11,000 and state unemployment compensation benefits of $2,000. He had no other source of income. The amount of state unemployment compensation benefits that should be included in John's 1987 adjusted gross income is

a. $2,000
b. $1,000
c. $ 500
d. $0

2M88#2. In 1987, Emil Gow won $5,000 in a state lottery. Also in 1987, Emil spent $400 for the purchase of lottery tickets. Emil elected the standard deduction on his 1987 income tax return. The amount of lottery winnings that should be included in Emil's 1987 taxable income is

a. $0
b. $2,000
c. $4,600
d. $5,000

2M88#3. In 1970, Betty Lane bought 100 shares of a listed corporation's stock for $8,000. In 1987, Betty sold this stock for $15,000. Betty had no other capital gains or losses in 1987. How much of the 1987 long-term capital gain should be included in Betty's 1987 taxable income?

a. $2,800
b. $3,500
c. $4,200
d. $7,000

2M88#4. For a married couple filing a 1987 joint return, the excess of net long-term capital loss over net short-term capital gain is

a. Reduced by 50% before being deducted from ordinary income.
b. Limited to a maximum deduction of $3,000 from ordinary income.
c. Allowed as a carryover against future capital gains up to a maximum period of five years.
d. Not deductible from ordinary income.

2M88#5. Al and Iris Oran, who are married, received $10,000 in 1987 as dividends from taxable domestic corporations. In the Orans' 1987 joint return, the amount of these dividends subject to tax is

a. $10,000
b. $ 9,900
c. $ 9,800
d. $ 8,500

2M88#6. During 1987, Ruth Loy received interest income as follows:

On U.S. Treasury certificates	$3,000
On refund of 1985 federal income tax	200

The total amount of interest subject to tax in Ruth's 1987 return is

a. $0
b. $ 200
c. $3,000
d. $3,200

2M88#9. Gary Judd is an individual proprietor trading as Lake Stores, an accrual basis enterprise that had been using the reserve method for determining bad debt expense for both book and tax purposes. At December 31, 1986, Lake's allowance for doubtful accounts ("bad debt reserve") was $20,000. In Lake's 1987 budget, it was estimated that $3,000 of trade accounts receivable would become worthless in 1987. However, actual bad debts amounted to $4,000 in 1987. In Lake's 1987 Schedule C of Form 1040, Lake is allowed

a. A $4,000 deduction for bad debts, but must also include $5,000 of the "reserve" in taxable income.
b. A $4,000 deduction for bad debts, and does **not** have to include any portion of the "reserve" in taxable income.

c. No deduction for bad debts since these bad debts should be charged against the "reserve."
d. A $1,000 deduction for bad debts, which is the excess of actual bad debts over the amount estimated.

B. Exclusions and Adjustments to Arrive at Adjusted Gross Income

2N91

Items 28 through 36* are based on the following:

Hall, a divorced person and custodian of her 12-year old child, filed her 1990 federal income tax return as head of a household. She submitted the following information to the CPA who prepared her 1990 return:

- The divorce agreement, executed in 1983, provides for Hall to receive $3,000 per month, of which $600 is designated as child support. After the child reaches 18, the monthly payments are to be reduced to $2,400 and are to continue until remarriage or death. However, for the year 1990, Hall received a total of only $5,000 from her former husband. Hall paid an attorney $2,000 in 1990 in a suit to collect the alimony owed.

- In June 1990, Hall's mother gifted her 100 shares of a listed stock. The donor's basis for this stock, which she bought in 1970, was $4,000, and market value on the date of the gift was $3,000. Hall sold this stock in July 1990 for $3,500. The donor paid no gift tax.

- During 1990, Hall spent a total of $1,000 for state lottery tickets. Her lottery winnings in 1990 totaled $200.

- Hall earned a salary of $25,000 in 1990. Hall was not covered by any type of retirement plan, but contributed $2,000 to an IRA in 1990.

- In 1990, Hall sold an antique that she bought in 1980 to display in her home. Hall paid $800 for the antique and sold it for $1,400, using the proceeds to pay a court-ordered judgment.

- Hall paid the following expenses in 1990 pertaining to the home that she owns: realty taxes, $3,400; mortgage interest, $7,000; casualty insurance, $490; assessment by city for construction of a sewer system, $910; interest of $1,000 on a personal, unsecured bank loan, the proceeds of which were used for home improvements. Hall does not rent out any portion of the home.

*The items omitted can be found in other Content Specification Groups.

32. Hall's $2,000 contribution to an IRA should be treated as
   a. An adjustment to income in arriving at adjusted gross income.
   b. A deduction from adjusted gross income subject to the 2% of adjusted gross income floor.
   c. A deduction from adjusted gross income **not** subject to the 2% of adjusted gross income floor.
   d. Nondeductible, with the interest income on the $2,000 to be deferred until withdrawal.

2M89

Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — $34,000.

The Hoyts itemized their deductions.

Among the Hoyts' cash receipts during 1988 were the following:

$1,000 dividends from taxable domestic corporations on stocks held in Sam's name.
$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for $9,000. The Hoyts had **no** other capital gains or losses in the current or prior years.
$6,000 first installment on a $75,000 life insurance policy payable to Ann in annual installments of $6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts' cash expenditures during 1988 were the following:

$2,000 transportation expenses required under the terms of Sam's employment contract were paid by Sam, an outside salesman. No reimbursement was received.
$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.
$800 appraisal fee to determine amount of fire loss.
$3,000 real estate tax on residence; $400 state and city sales taxes; $900 state income tax.
$100 contribution to a recognized political party.

*The items omitted can be found in other Content Specification Groups.

46. What portion of the $6,000 installment on the life insurance policy is excludible from 1988 gross income in arriving at Hoyts' adjusted gross income?
   a. $0
   b. $1,000
   c. $5,000
   d. $6,000

2N88#10. Which one of the following types of allowable deductions can be claimed as a deduction in arriving at an individual's 1988 adjusted gross income?
   a. Unreimbursed business expenses of an outside salesman-employee.
   b. Personal casualty losses.
   c. Charitable contributions.
   d. Alimony payments.

2N88#11. Sol and Julia Crane are married, and filed a joint return for 1987. Sol earned a salary of $80,000 in 1987 from his job at Troy Corp., where Sol is covered by his employer's pension plan. In addition, Sol and Julia earned interest of $3,000 in 1987 on their joint savings account. Julia is not employed, and the couple had no other income. On January 15, 1988, Sol contributed $2,000 to an IRA for himself, and $250 to an IRA for his spouse. The allowable IRA deduction in the Cranes' 1987 joint return is
   a. $0
   b. $ 250
   c. $2,000
   d. $2,250

2M88#15. Paul and Lois Lee, both age 50, are married and filed a joint return for 1987. Their 1987 adjusted gross income was $80,000, including Paul's $75,000 salary. Lois had no income of her own. Neither spouse was covered by an employer-sponsored pension plan. What amount could the Lees contribute to IRAs for 1987 to take advantage of their maximum allowable IRA deduction in their 1987 return?
   a. $0
   b. $2,000
   c. $2,250
   d. $4,000

C. Gain or Loss on Property Transactions

2N91

Items 28 through 36* are based on the following:

Hall, a divorced person and custodian of her 12-year old child, filed her 1990 federal income tax return as head of a household. She submitted the following information to the CPA who prepared her 1990 return:

- The divorce agreement, executed in 1983, provides for Hall to receive $3,000 per month, of which $600 is designated as child support. After the child reaches 18, the monthly payments are to be reduced to $2,400 and are to continue until remarriage or death. However, for the year 1990, Hall received a total of only $5,000 from her former husband. Hall paid an attorney $2,000 in 1990 in a suit to collect the alimony owed.

- In June 1990, Hall's mother gifted her 100 shares of a listed stock. The donor's basis for this stock, which she bought in 1970, was $4,000, and market value on the date of the gift was $3,000. Hall sold this stock in July 1990 for $3,500. The donor paid no gift tax.

- During 1990, Hall spent a total of $1,000 for state lottery tickets. Her lottery winnings in 1990 totaled $200.

- Hall earned a salary of $25,000 in 1990. Hall was not covered by any type of retirement plan, but contributed $2,000 to an IRA in 1990.

- In 1990, Hall sold an antique that she bought in 1980 to display in her home. Hall paid $800 for the antique and sold it for $1,400, using the proceeds to pay a court-ordered judgment.

- Hall paid the following expenses in 1990 pertaining to the home that she owns: realty taxes, $3,400; mortgage interest, $7,000; casualty insurance, $490; assessment by city for construction of a sewer system, $910; interest of $1,000 on a personal, unsecured bank loan, the proceeds of which were used for home improvements. Hall does not rent out any portion of the home.

33. The $600 gain that Hall realized on the sale of the antique should be treated as
   a. Ordinary income.
   b. Long-term capital gain.
   c. An involuntary conversion.
   d. A nontaxable antiquities transaction.

2N90#28. Joe Hall owns a limousine for use in his personal service business of transporting passengers to airports. The limousine's adjusted basis is $40,000. In addition, Hall owns his personal residence and furnishings, that together cost him $280,000. Hall's capital assets amount to
   a. $320,000
   b. $280,000
   c. $ 40,000
   d. $0

2N90#29. Fred Berk bought a plot of land with a cash payment of $40,000 and a purchase money mortgage of $50,000. In addition, Berk paid $200 for a title insurance policy. Berk's basis in this land is
   a. $40,000
   b. $40,200
   c. $90,000
   d. $90,200

*The items omitted can be found in other Content Specification Groups.

2N90#30. In 1989, Joan Reed exchanged commercial real estate that she owned for other commercial real estate plus cash of $50,000. The following additional information pertains to this transaction:

Property given up by Reed	
Fair market value	$500,000
Adjusted basis	300,000
Property received by Reed	
Fair market value	450,000

What amount of gain should be recognized in Reed's 1989 income tax return?
a. $200,000
b. $100,000
c. $ 50,000
d. $0

2M89#41. In 1989, Ruth Lee sold a painting for $25,000 that she had bought for her personal use in 1979 at a cost of $10,000. In her 1989 return, Lee should treat the sale of the painting as a transaction resulting in
a. Ordinary income.
b. Long-term capital gain.
c. Section 1231 gain.
d. No taxable gain.

2M89#42. The following information pertains to the sale of Al Oran's principal residence:

Date of sale	May 1989
Date of purchase	May 1979
Net sales price	$260,000
Adjusted basis	$ 70,000

In June 1989, Oran (age 70) bought a smaller residence for $90,000. Oran elected to avail himself of the exclusion of realized gain available to taxpayers age 55 and over. What amount of gain should Oran recognize in 1989 on the sale of his residence?
a. $45,000
b. $65,000
c. $70,000
d. $90,000

2M89#52. On June 1, 1988, Ben Rork sold 500 shares of Kul Corp. stock. Rork had received this stock on May 1, 1988 as a bequest from the estate of his uncle, who died on March 1, 1988. Rork's basis was determined by reference to the stock's fair market value on March 1, 1988. Rork's holding period for this stock was
a. Short-term.
b. Long-term.
c. Short-term if sold at a gain; long-term if sold at a loss.
d. Long-term if sold at a gain; short-term if sold at a loss.

D. Deductions From Adjusted Gross Income

2N91#21. Which of the following requirements must be met in order for a single individual to qualify for the additional standard deduction?

	Must be age 65 or older or blind	*Must support dependent child or aged parent*
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

2N91
Items 28 through 36* are based on the following:

Hall, a divorced person and custodian of her 12-year old child, filed her 1990 federal income tax return as head of a household. She submitted the following information to the CPA who prepared her 1990 return:

- The divorce agreement, executed in 1983, provides for Hall to receive $3,000 per month, of which $600 is designated as child support. After the child reaches 18, the monthly payments are to be reduced to $2,400 and are to continue until remarriage or death. However, for the year 1990, Hall received a total of only $5,000 from her former husband. Hall paid an attorney $2,000 in 1990 in a suit to collect the alimony owed.

- In June 1990, Hall's mother gifted her 100 shares of a listed stock. The donor's basis for this stock, which she bought in 1970, was $4,000, and market value on the date of the gift was $3,000. Hall sold this stock in July 1990 for $3,500. The donor paid no gift tax.

- During 1990, Hall spent a total of $1,000 for state lottery tickets. Her lottery winnings in 1990 totaled $200.

- Hall earned a salary of $25,000 in 1990. Hall was not covered by any type of retirement plan, but contributed $2,000 to an IRA in 1990.

- In 1990, Hall sold an antique that she bought in 1980 to display in her home. Hall paid $800 for the antique and sold it for $1,400, using the proceeds to pay a court-ordered judgment.

- Hall paid the following expenses in 1990 pertaining to the home that she owns: realty taxes, $3,400; mortgage interest, $7,000; casualty insurance, $490; assessment by city for construction of a sewer system, $910; interest of $1,000 on a personal, un-

*The items omitted can be found in other Content Specification Groups.

secured bank loan, the proceeds of which were used for home improvements. Hall does not rent out any portion of the home.

34. What amount should be claimed in Hall's 1990 return as an itemized deduction for interest?
   a. $7,000
   b. $7,100
   c. $7,200
   d. $8,000

35. The $910 sewer system assessment imposed by the city in 1990 is
   a. Allowed with the realty taxes as an itemized deduction for taxes.
   b. Allowed as an itemized deduction subject to the 2% of adjusted gross income floor.
   c. Deductible in arriving at adjusted gross income.
   d. Not deductible in 1990.

36. The casualty insurance premium of $490 is
   a. Allowed as an itemized deduction subject to the $100 floor and the 10% of adjusted gross income floor.
   b. Allowed as an itemized deduction subject to the 2% of gross income floor.
   c. Deductible in arriving at adjusted gross income.
   d. Not deductible in 1990.

2M91#26. Dale received $1,000 in 1990 for jury duty. In exchange for regular compensation from her employer during the period of jury service, Dale was required to remit the entire $1,000 to her employer in 1990. In Dale's 1990 income tax return, the $1,000 jury duty fee should be
   a. Claimed in full as an itemized deduction.
   b. Claimed as an itemized deduction to the extent exceeding 2% of adjusted gross income.
   c. Deducted from gross income in arriving at adjusted gross income.
   d. Included in taxable income without a corresponding offset against other income.

2M91#27. For regular tax purposes, with regard to the itemized deduction for qualified residence interest, home equity indebtedness incurred in 1991
   a. Includes acquisition indebtedness secured by a qualified residence.
   b. May exceed the fair market value of the residence.
   c. Must exceed the taxpayer's net equity in the residence.
   d. Is limited to $100,000 on a joint income tax return.

2M91#29. An individual's losses on transactions entered into for personal purposes are deductible only if
   a. The losses qualify as casualty or theft losses.
   b. The losses can be characterized as hobby losses.
   c. The losses do not exceed $3,000 ($6,000 on a joint return).
   d. No part of the transactions was entered into for profit.

2M91#30. Ruth and Mark Cline are married and will file a joint 1991 income tax return. Among their expenditures during 1991 were the following discretionary costs that they incurred for the sole purpose of improving their physical appearance and self-esteem:

Face lift for Ruth, performed by a licensed surgeon	$5,000
Hair transplant for Mark, performed by a licensed surgeon	3,600

Disregarding the adjusted gross income percentage threshold, what total amount of the aforementioned doctors' bills may be claimed by the Clines in their 1991 return as qualifying medical expenses?
   a. $0
   b. $3,600
   c. $5,000
   d. $8,600

2M91#31. During 1990, Scott charged $4,000 on his credit card for his dependent son's medical expenses. Payment to the credit card company had not been made by the time Scott filed his income tax return in 1991. However, in 1990, Scott paid a physician $2,800 for the medical expenses of his wife, who died in 1989. Disregarding the adjusted gross income percentage threshold, what amount could Scott claim in his 1990 income tax return for medical expenses?
   a. $0
   b. $2,800
   c. $4,000
   d. $6,800

2M91#32. Which one of the following types of itemized deductions is included in the category of unreimbursed expenses deductible only if the aggregate of such expenses exceeds 2% of the taxpayer's adjusted gross income?
   a. Interest expense.
   b. Medical expenses.
   c. Employee moving expenses.
   d. Tax return preparation fees.

2N90#31. Marc Clay was unemployed for the entire year 1988. In January 1989, Clay obtained full-time employment 40 miles away from the city where he had resided during the ten years preceding 1989. Clay kept his new job for the entire year 1989. In January 1989, Clay paid direct moving expenses of $300 in relocating to his new city of residence, but he received **no** reimbursement for these expenses. In his 1989 income tax return, Clay's direct moving expenses are

a. Not deductible.
b. Fully deductible only if Clay itemizes his deductions.
c. Fully deductible from gross income in arriving at adjusted gross income.
d. Deductible subject to a 2% threshold if Clay itemizes his deductions.

2N90#32. In 1989, Smith paid $6,000 to the tax collector of Wek City for realty taxes on a two-family house owned by Smith's mother. Of this amount, $2,800 covered back taxes for 1988, and $3,200 covered 1989 taxes. Smith resides on the second floor of the house, and his mother resides on the first floor. In Smith's itemized deductions on his 1989 return, what amount was Smith entitled to claim for realty taxes?

a. $6,000
b. $3,200
c. $3,000
d. $0

2N90#33. Which one of the following expenditures qualifies as a deductible medical expense for tax purposes?

a. Vitamins for general health **not** prescribed by a physician.
b. Health club dues.
c. Transportation to physician's office for required medical care.
d. Mandatory employment taxes for basic coverage under Medicare A.

2N90#34. Which one of the following statements is correct with regard to an individual taxpayer who has elected to amortize the premium on a bond that yields taxable interest?

a. The amortization is treated as an itemized deduction.
b. The amortization is **not** treated as a reduction of taxable income.
c. The bond's basis is reduced by the amortization.
d. The bond's basis is increased by the amortization.

2M89
Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — $34,000.

The Hoyts itemized their deductions.

Among the Hoyts' cash receipts during 1988 were the following:

$1,000 dividends from taxable domestic corporations on stocks held in Sam's name.
$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for $9,000. The Hoyts had **no** other capital gains or losses in the current or prior years.
$6,000 first installment on a $75,000 life insurance policy payable to Ann in annual installments of $6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts' cash expenditures during 1988 were the following:

$2,000 transportation expenses required under the terms of Sam's employment contract were paid by Sam, an outside salesman. No reimbursement was received.
$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.
$800 appraisal fee to determine amount of fire loss.
$3,000 real estate tax on residence; $400 state and city sales taxes; $900 state income tax.
$100 contribution to a recognized political party.

48. What amount of fire loss were the Hoyts entitled to deduct as an itemized deduction on their 1988 return?

a. $5,000
b. $2,500
c. $1,600
d. $1,500

49. What total amount was deductible for taxes on the Hoyts' 1988 return?

a. $4,300
b. $3,900
c. $3,400
d. $3,000

50. The unreimbursed employee's transportation expenses paid by Sam in 1988 were

a. Deductible from gross income in arriving at adjusted gross income.
b. Subject to the 2% of adjusted gross income floor for miscellaneous itemized deductions.
c. Fully deductible as an itemized deduction.
d. Not deductible.

*The items omitted can be found in other Content Specification Groups.

51. The appraisal fee to determine the amount of the Hoyts' fire loss was
   a. Deductible from gross income in arriving at adjusted gross income.
   b. Subject to the 2% of adjusted gross income floor for miscellaneous itemized deductions.
   c. Deductible after reducing the amount by $100.
   d. Not deductible.

2N88#13. In 1988, Lyons paid $3,000 to the tax collector of Maple Township for realty taxes on a two-family house owned by Lyons' mother. Of this amount, $1,400 covered back taxes for 1987, and $1,600 was in payment of 1988 taxes. Lyons resides on the second floor of the house, and his mother resides on the first floor. In Lyons' itemized deductions on his 1988 return, what amount may Lyons claim for realty taxes?
   a. $0
   b. $1,500
   c. $1,600
   d. $3,000

2N88#15. The following information pertains to Cole's personal residence, which sustained casualty fire damage in 1987:

Adjusted basis	$150,000
Fair market value immediately before the fire	200,000
Fair market value immediately after the fire	180,000
Fire damage repairs paid for by Cole in 1987	10,000

The house was uninsured. Before consideration of any "floor" or other limitation on tax deductibility, the amount of this 1987 casualty loss was
   a. $30,000
   b. $20,000
   c. $10,000
   d. $0

2M88#7. The unreimbursed 1987 employee travel expenses of an outside salesperson are
   a. Fully deductible from gross income in arriving at adjusted gross income.
   b. Deductible only as miscellaneous itemized deductions subject to a 2% floor.
   c. Fully deductible only as miscellaneous itemized deductions.
   d. Not deductible.

2M88#12. If both a husband and wife are wage earners and file a 1987 joint return, a two-earner wage deduction may be claimed
   a. As an exclusion in arriving at adjusted gross income.
   b. As a special deduction from adjusted gross income.
   c. As a miscellaneous itemized deduction subject to a 2% floor.
   d. Under **no** circumstances.

2M88#13. The unreimbursed moving expenses of an employee who takes a new job 100 miles away from a previous residence and place of employment are
   a. Fully deductible from gross income in arriving at adjusted gross income.
   b. Deductible only as miscellaneous itemized deductions subject to a 2% floor.
   c. Fully deductible only as miscellaneous itemized deductions.
   d. Not deductible.

2M88#14. Alan Curtis, who is single, had an adjusted gross income of $40,000 in 1987, and he used the standard deduction in his 1987 return. During 1987, Alan contributed $300 to the building fund of State University. What amount was deductible for contributions in Alan's 1987 return?
   a. $0
   b. $ 50
   c. $100
   d. $300

E. Filing Status and Exemptions

2M91#34. A husband and wife can file a joint return even if
   a. The spouses have different tax years, provided that both spouses are alive at the end of the year.
   b. The spouses have different accounting methods.
   c. Either spouse was a nonresident alien at any time during the tax year, provided that at least one spouse makes the proper election.
   d. They were divorced before the end of the tax year.

2N90#24. Al and Mary Lew are married and filed a joint 1989 income tax return in which they validly claimed the $2,000 personal exemption for their dependent 17-year old daughter, Doris. Since Doris earned $5,400 in 1989 from a part-time job at the college she attended full-time, Doris was also required to file a 1989 income tax return. What amount was Doris entitled to claim as a personal exemption in her 1989 individual income tax return?
   a. $0
   b. $1,000
   c. $2,000
   d. $3,000

2M89
Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

*The items omitted can be found in other Content Specification Groups.

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — $34,000.

The Hoyts itemized their deductions.

Among the Hoyts' cash receipts during 1988 were the following:

$1,000 dividends from taxable domestic corporations on stocks held in Sam's name.
$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for $9,000. The Hoyts had **no** other capital gains or losses in the current or prior years.
$6,000 first installment on a $75,000 life insurance policy payable to Ann in annual installments of $6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts' cash expenditures during 1988 were the following:

$2,000 transportation expenses required under the terms of Sam's employment contract were paid by Sam, an outside salesman. No reimbursement was received.
$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.
$800 appraisal fee to determine amount of fire loss.
$3,000 real estate tax on residence; $400 state and city sales taxes; $900 state income tax.
$100 contribution to a recognized political party.

43. How many personal exemptions were the Hoyts entitled to claim on their 1988 return?
   a. 2
   b. 3
   c. 4
   d. 5

2N88#16. Emil Gow's wife died in 1985. Emil did not remarry, and he continued to maintain a home for himself and his dependent infant child during 1986 and 1987, providing full support for himself and his child during these years. For 1985, Emil properly filed a joint return. For 1987, Emil's filing status is
   a. Single.
   b. Head of household.
   c. Qualifying widower with dependent child.
   d. Married filing joint return.

2M88#11. Ben and Doris Carr are married and filed a joint 1987 return. Ben is 72 and blind. Doris is 70 and has normal vision. How many personal exemptions may the Carrs claim on their 1987 return?
   a. 2
   b. 3
   c. 4
   d. 5

F. Tax Computations and Credits

2N91#22. Kent qualified for the earned income credit in 1990. This credit could result in a
   a. Refund even if Kent had no tax withheld from wages.
   b. Refund only if Kent had tax withheld from wages.
   c. Carryback or carryforward for any unused portion.
   d. Subtraction from adjusted gross income to arrive at taxable income.

2M91#33. An employee who has had social security tax withheld in an amount greater than the maximum for a particular year, may claim
   a. Such excess as either a credit or an itemized deduction, at the election of the employee, if that excess resulted from correct withholding by two or more employers.
   b. Reimbursement of such excess from his employers, if that excess resulted from correct withholding by two or more employers.
   c. The excess as a credit against income tax, if that excess resulted from correct withholding by two or more employers.
   d. The excess as a credit against income tax, if that excess was withheld by one employer.

2N90#23. Which one of the following statements is correct with regard to the earned income credit?
   a. The credit is available only to those individuals whose earned income is equal to adjusted gross income.
   b. For purposes of the earned income test, "earned income" includes workers' compensation benefits.
   c. The credit can result in a refund even if the individual had **no** tax withheld from wages.
   d. The credit is available to married couples who are childless.

2M89
Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — $34,000.

*The items omitted can be found in other Content Specification Groups.

The Hoyts itemized their deductions.

Among the Hoyts' cash receipts during 1988 were the following:

$1,000 dividends from taxable domestic corporations on stocks held in Sam's name.
$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for $9,000. The Hoyts had **no** other capital gains or losses in the current or prior years.
$6,000 first installment on a $75,000 life insurance policy payable to Ann in annual installments of $6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts' cash expenditures during 1988 were the following:

$2,000 transportation expenses required under the terms of Sam's employment contract were paid by Sam, an outside salesman. No reimbursement was received.
$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of $50,000. Fair market value was $60,000 before the fire and $55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.
$800 appraisal fee to determine amount of fire loss.
$3,000 real estate tax on residence; $400 state and city sales taxes; $900 state income tax.
$100 contribution to a recognized political party.

47. What amount of the $100 political contribution were the Hoyts entitled to claim as a credit against their 1988 tax?
a. $0
b. $ 25
c. $ 50
d. $100

2M88#8. The maximum allowable credit for political contributions on a 1987 joint return is
a. $100
b. $ 50
c. $ 25
d. $0

G. Statute of Limitations

2N90#21. Keen, a calendar-year taxpayer, reported a gross income of $100,000 on his 1989 income tax return. Inadvertently omitted from gross income was a $20,000 commission that should have been included in 1989. Keen filed his 1989 return on March 15, 1990. To collect the tax on the $20,000 omission, the Internal Revenue Service must assert a notice of deficiency **no** later than
a. March 15, 1993.
b. April 15, 1993.
c. March 15, 1996.
d. April 15, 1996.

2N90#22. If an individual paid income tax in 1989 but did **not** file a 1989 return because his income was insufficient to require the filing of a return, the deadline for filing a refund claim is
a. Two years from the date the tax was paid.
b. Two years from the date a return would have been due.
c. Three years from the date the tax was paid.
d. Three years from the date a return would have been due.

2M89#56. On April 15, 1989, a married couple filed their joint 1988 calendar-year return showing gross income of $80,000. Their return had been prepared by a professional tax preparer who mistakenly omitted $30,000 of income which, in good faith, the preparer considered to be nontaxable. No information with regard to this omitted income was disclosed on the return or attached statements. By what date must the Internal Revenue Service assert a notice of deficiency before the statute of limitations expires?
a. December 31, 1991.
b. April 15, 1992.
c. December 31, 1994.
d. April 15, 1995.

H. Estate and Gift Taxation and Income Taxation of Estates and Trusts

2N91#23. The federal estate tax may be reduced by a credit for state
a. Death taxes.
b. Gift taxes on gifts made two years before death.
c. Income taxes paid in the year of death.
d. Intangible property taxes.

2N91#24. The 1990 standard deduction for a trust or an estate in the fiduciary income tax return is
a. $0
b. $650
c. $750
d. $800

2N91#25. Which of the following fiduciary entities are required to use the calendar year as their taxable period for income tax purposes?

	Estates	*Trusts (except those that are tax-exempt)*
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

2N91#26. During 1990, Blake transferred a corporate bond with a face amount and fair market value of $20,000 to a trust for the benefit of her 16-year old child. Annual interest on this bond is $2,000, which is to be accumulated in the trust and distributed to the child on reaching the age of 21. The bond is then to be distributed to the donor or her successor-in-interest in liquidation of the trust. Present value of the total interest to be received by the child is $8,710. The amount of the gift that is excludable from taxable gifts is

a. $20,000
b. $10,000
c. $ 8,710
d. $0

2N91#27. Within how many months after the date of a decedent's death is the federal estate tax return (Form 706) due if **no** extension of time for filing is granted?

a. 9
b. 6
c. 4½
d. 3½

2N91#37. Under the unified rate schedule,

a. Lifetime taxable gifts are taxed on a noncumulative basis.
b. Transfers at death are taxed on a noncumulative basis.
c. Lifetime taxable gifts and transfers at death are taxed on a cumulative basis.
d. The gift tax rates are 5% higher than the estate tax rates.

2N91#38. The generation-skipping transfer tax is imposed

a. Instead of the gift tax.
b. Instead of the estate tax.
c. As a separate tax in addition to the gift and estate taxes.
d. On transfers of future interest to beneficiaries who are more than one generation above the donor's generation.

2N91#39. Ordinary and necessary administration expenses paid by the fiduciary of an estate are deductible

a. Only on the fiduciary income tax return (Form 1041) and never on the federal estate tax return (Form 706).
b. Only on the federal estate tax return and never on the fiduciary income tax return.
c. On the fiduciary income tax return only if the estate tax deduction is waived for these expenses.
d. On both the fiduciary income tax return and on the estate tax return by adding a tax computed on the proportionate rates attributable to both returns.

2N91#40. Which of the following requires filing a gift tax return, if the transfer exceeds the available annual gift tax exclusion?

a. Medical expenses paid directly to a physician on behalf of an individual unrelated to the donor.
b. Tuition paid directly to an accredited university on behalf of an individual unrelated to the donor.
c. Payments for college books, supplies, and dormitory fees on behalf of an individual unrelated to the donor.
d. Campaign expenses paid to a political organization.

2M91#35. Fred and Amy Kehl, both U.S. citizens, are married. All of their real and personal property is owned by them as tenants by the entirety or as joint tenants with right of survivorship. The gross estate of the first spouse to die

a. Includes 50% of the value of all property owned by the couple, regardless of which spouse furnished the original consideration.
b. Includes only the property that had been acquired with the funds of the deceased spouse.
c. Is governed by the federal statutory provisions relating to jointly held property, rather than by the decedent's interest in community property vested by state law, if the Kehls reside in a community property state.
d. Includes one-third of the value of all real estate owned by the Kehls, as the dower right in the case of the wife or curtesy right in the case of the husband.

2M91#36. In connection with a "buy-sell" agreement funded by a cross-purchase insurance arrangement, business associate Adam bought a policy on Burr's life to finance the purchase of Burr's interest. Adam, the beneficiary, paid the premiums and retained all incidents of ownership. On the death of Burr, the insurance proceeds will be

a. Includible in Burr's gross estate, if Burr owns 50% or more of the stock of the corporation.
b. Includible in Burr's gross estate only if Burr had purchased a similar policy on Adam's life at the same time and for the same purpose.
c. Includible in Burr's gross estate, if Adam has the right to veto Burr's power to borrow on the policy that Burr owns on Adam's life.
d. Excludible from Burr's gross estate.

2M91#37. An executor of a decedent's estate that has only U.S. citizens as beneficiaries is required to file a fiduciary income tax return, if the estate's gross income for the year is at least

a. $ 400
b. $ 500
c. $ 600
d. $1,000

2M91#38. The charitable contribution deduction on an estate's fiduciary income tax return is allowable

a. If the decedent died intestate.
b. To the extent of the same adjusted gross income limitation as that on an individual income tax return.
c. Only if the decedent's will specifically provides for the contribution.
d. Subject to the 2% threshold on miscellaneous itemized deductions.

2M91#39. Raff died in 1989 leaving her entire estate to her only child. Raff's will gave full discretion to the estate's executor with regard to distributions of income. For 1990, the estate's distributable net income was $15,000, of which $9,000 was paid to the beneficiary. None of the income was tax exempt. What amount can be claimed on the estate's 1990 fiduciary income tax return for the distributions deduction?

a. $0
b. $ 6,000
c. $ 9,000
d. $15,000

2M91#40. On July 1, 1989, Vega made a transfer by gift in an amount sufficient to require the filing of a gift tax return. Vega was still alive in 1990. If Vega did **not** request an extension of time for filing the 1989 gift tax return, the due date for filing was

a. March 15, 1990.
b. April 15, 1990.
c. June 15, 1990.
d. June 30, 1990.

2N90#35. Jan, an unmarried individual, gave the following outright gifts in 1989:

Donee	*Amount*	*Use by donee*
Jones	$15,000	Downpayment on house
Craig	12,000	College tuition
Kande	5,000	Vacation trip

Jan's 1989 exclusions for gift tax purposes should total

a. $27,000
b. $25,000
c. $20,000
d. $ 9,000

2N90#36. When Jim and Nina became engaged in April 1989, Jim gave Nina a ring that had a fair market value of $50,000. After their wedding in July 1989, Jim gave Nina $75,000 in cash so that Nina could have her own bank account. Both Jim and Nina are U.S. citizens. What was the amount of Jim's 1989 marital deduction?

a. $0
b. $ 75,000
c. $115,000
d. $125,000

2N90#37. Following are the fair market values of Wald's assets at the date of death:

Personal effects and jewelry	$150,000
Land bought by Wald with Wald's funds five years prior to death and held with Wald's sister as joint tenants with right of survivorship	800,000

The executor of Wald's estate did not elect the alternate valuation date. The amount includible as Wald's gross estate in the federal estate tax return is

a. $150,000
b. $550,000
c. $800,000
d. $950,000

2N90#38. If the executor of a decedent's estate elects the alternate valuation date and none of the property included in the gross estate has been sold or distributed, the estate assets must be valued as of how many months after the decedent's death?

a. 3
b. 6
c. 9
d. 12

2N90#39. Income in respect of a cash basis decedent

a. Covers income earned before the taxpayer's death but **not** collected until after death.
b. Receives a stepped-up basis in the decedent's estate.
c. Must be included in the decedent's final income tax return.
d. Cannot receive capital gain treatment.

2N90#40. Which one of the following is a valid deduction from a decedent's gross estate?

a. Expenses of administering and settling the estate.
b. State inheritance tax.
c. Income tax paid on income earned and received after the decedent's death.
d. Federal estate tax.

2M89#58. If an individual donor makes a gift of future interest whereby the donee is to receive possession of the gift at some future time, the annual exclusion for gift tax purposes is

a. $0
b. $ 3,000
c. $ 5,000
d. $10,000

2M89#59. Eng and Lew, both U.S. citizens, died in 1989. Eng made taxable lifetime gifts of $100,000 that are **not** included in Eng's gross estate. Lew made no lifetime gifts. At the dates of death, Eng's gross estate was $300,000, and Lew's gross estate was $400,000. A federal estate tax return must be filed for

	Eng	*Lew*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

2M89#60. With regard to the federal estate tax, the alternate valuation date

a. Is required to be used if the fair market value of the estate's assets has increased since the decedent's date of death.
b. If elected on the first return filed for the estate, may be revoked in an amended return provided that the first return was filed on time.
c. Must be used for valuation of the estate's liabilities if such date is used for valuation of the estate's assets.
d. Can be elected only if its use decreases both the value of the gross estate and the estate tax liability.

2N88#17. Raff created a joint bank account for himself and his friend's son, Dave. There is a gift to Dave when

a. Raff creates the account.
b. Raff dies.
c. Dave draws on the account for his own benefit.
d. Dave is notified by Raff that the account has been created.

2N88#18. Proceeds of a life insurance policy payable to the estate's executor, as the estate's representative, are

a. Includible in the decedent's gross estate only if the premiums had been paid by the insured.
b. Includible in the decedent's gross estate only if the policy was taken out within three years of the insured's death under the "contemplation of death" rule.
c. Always includible in the decedent's gross estate.
d. Never includible in the decedent's gross estate.

2N88#19. Ross, a calendar-year, cash basis taxpayer who died in June 1988, was entitled to receive a $10,000 accounting fee that had not been collected before the date of death. The executor of Ross' estate collected the full $10,000 in July 1988. This $10,000 should appear in

a. Only the decedent's final individual income tax return.
b. Only the estate's fiduciary income tax return.
c. Only the estate tax return.
d. Both the fiduciary income tax return and the estate tax return.

2N88#20. In 1987, Blum, who is single, gave an outright gift of $50,000 to a friend, Gould, who needed the money to pay medical expenses. In filing the 1987 gift tax return, Blum was entitled to a maximum exclusion of

a. $20,000
b. $10,000
c. $ 3,000
d. $0

2M88#17. All trusts, except tax exempt trusts,

a. Must adopt a calendar year, except for existing trusts with fiscal years ended in 1987.
b. May adopt a calendar year or any fiscal year.
c. Must adopt a calendar year regardless of the year the trust was established.
d. Must use the same taxable year as that of its principal beneficiary.

2M88#18. For income tax purposes, all estates

a. Must adopt a calendar year, except for existing estates with fiscal years ended in 1987.
b. May adopt a calendar year or any fiscal year.
c. Must adopt a calendar year regardless of the year the estate was established.
d. Must use the same taxable year as that of its principal beneficiary.

2M88#19. With regard to estimated income tax, estates

a. Must make quarterly estimated tax payments starting no later than the second quarter following the one in which the estate was established.
b. Are exempt from paying estimated tax during the estate's first two taxable years.
c. Must make quarterly estimated tax payments only if the estate's income is required to be distributed currently.
d. Are **not** required to make payments of estimated tax.

2M88#20. A complex trust is a trust that

a. Must distribute income currently, but is prohibited from distributing principal during the taxable year.
b. Invests only in corporate securities and is prohibited from engaging in short-term transactions.
c. Permits accumulation of current income, provides for charitable contributions, or distributes principal during the taxable year.
d. Is exempt from payment of income tax since the tax is paid by the beneficiaries.

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

A. Determination of Taxable Income or Loss

2N91#41. A corporation's capital loss carryback or carryover is
a. Not allowable under current law.
b. Limited to $3,000.
c. Always treated as a long-term capital loss.
d. Always treated as a short-term capital loss.

2N91#42. Lyle Corp. is a distributor of pharmaceuticals and sells only to retail drug stores. During 1990, Lyle received unsolicited samples of nonprescription drugs from a manufacturer. Lyle donated these drugs in 1990 to a qualified exempt organization and deducted their fair market value as a charitable contribution. What should be included as gross income in Lyle's 1990 return for receipt of these samples?
a. Fair market value.
b. Net discounted wholesale price.
c. $25 nominal value assigned to gifts.
d. $0

2N91#44. Andi Corp. issued $1,000,000 face amount of bonds in 1985 and established a sinking fund to pay the debt at maturity. The bondholders appointed an independent trustee to invest the sinking fund contributions and to administer the trust. In 1990, the sinking fund earned $60,000 in interest on bank deposits and $8,000 in net long-term capital gains. All of the trust income is accumulated with Andi's periodic contributions so that the aggregate amount will be sufficient to pay the bonds when they mature. What amount of trust income was taxable to Andi in 1990?
a. $0
b. $ 8,000
c. $60,000
d. $68,000

2N91#45. Par Corp. acquired the assets of its wholly owned subsidiary, Sub Corp., under a plan that qualified as a tax-free complete liquidation of Sub. Which of the following of Sub's unused carryovers may be transferred to Par?

	Excess charitable contributions	*Net operating loss*
a.	No	Yes
b.	Yes	No
c.	No	No
d.	Yes	Yes

2N91#46. In a C corporation's computation of the maximum allowable deduction for contributions, what percentage limitation should be applied to the applicable base amount?
a. 5%
b. 10%
c. 30%
d. 50%

2N91#47. In the case of a corporation that is **not** a financial institution, which of the following statements is correct with regard to the deduction for bad debts?
a. Either the reserve method or the direct charge-off method may be used, if the election is made in the corporation's first taxable year.
b. On approval from the IRS, a corporation may change its method from direct charge-off to reserve.
c. If the reserve method was consistently used in prior years, the corporation may take a deduction for a reasonable addition to the reserve for bad debts.
d. A corporation is required to use the direct charge-off method rather than the reserve method.

2N91#48. The costs of organizing a corporation
a. May be deducted in full in the year in which these costs are incurred even if paid in later years.
b. May be deducted only in the year in which these costs are paid.
c. May be amortized over a period of not less than 60 months even if these costs are capitalized on the company's books.
d. Are nondeductible capital expenditures.

2N91#49. Would the following expense items be reported on Schedule M-1 of the corporation income tax return showing the reconciliation of income per books with income per return?

	Interest incurred on loan to carry U.S. obligations	*Provision for state corporation income tax*
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

2N91#50. Page Corp. owns 80% of Saga Corp.'s outstanding capital stock. Saga's capital stock consists of 50,000 shares of common stock issued and outstanding. Saga's 1990 net income was $70,000. During 1990, Saga declared and paid dividends of $30,000. In conformity with generally accepted accounting principles, Page recorded the following entries in 1990:

	Debit	*Credit*
Investment in Saga Corp. common stock	$56,000	
Equity in earnings of subsidiary		$56,000
Cash	24,000	
Investment in Saga Corp. common stock		24,000

In its 1990 consolidated tax return, Page should report dividend revenue of
a. $0
b. $ 4,800
c. $ 7,200
d. $24,000

2M91#44. The rule limiting the allowability of passive activity losses and credits applies to
a. Partnerships.
b. S corporations.
c. Personal service corporations.
d. Widely-held C corporations.

2M91#45. Nyle Corp. owned 100 shares of Beta Corp. stock that it bought in 1980 for $9 per share. In 1990, when the fair market value of the Beta stock was $20 per share, Nyle distributed this stock to a noncorporate shareholder. Nyle's recognized gain on this distribution was
a. $2,000
b. $1,100
c. $ 900
d. $0

2M91#46. A corporation's capital losses are
a. Deductible only to the extent of the corporation's capital gains.
b. Deductible from the corporation's ordinary income to the extent of $3,000.
c. Carried back three years and forward 15 years.
d. Forfeited if the corporation had **no** capital gains in the year in which the capital losses were incurred.

2M91#47. The corporate dividends-received deduction
a. Must exceed the applicable percentage of the recipient shareholder's taxable income.
b. Is affected by a requirement that the investor corporation must own the investee's stock for a specified minimum holding period.
c. Is unaffected by the percentage of the investee's stock owned by the investor corporation.
d. May be claimed by S corporations.

2M91#49. Foreign income taxes paid by a corporation
a. May be claimed either as a deduction or as a credit, at the option of the corporation.
b. May be claimed only as a deduction.
c. May be claimed only as a credit.
d. Do **not** qualify either as a deduction or as a credit.

2M91#50. Under the modified accelerated cost recovery system (MACRS) of depreciation for property placed in service after 1986,
a. Used tangible depreciable property is excluded from the computation.
b. Salvage value is ignored for purposes of computing the MACRS deduction.
c. No type of straight-line depreciation is allowable.
d. The recovery period for depreciable realty must be at least 27.5 years.

2M91#51. The minimum total voting power that a parent corporation must have in a subsidiary's stock in order to be eligible for the filing of a consolidated return is
a. 20%
b. 50%
c. 51%
d. 80%

2M91#52. With regard to depreciation computations made under the general MACRS method, the half-year convention provides that
a. One-half of the first year's depreciation is allowed in the year in which the property is placed in service, regardless of when the property is placed in service during the year, and a half-year's depreciation is allowed for the year in which the property is disposed of.
b. The deduction will be based on the number of months the property was in service, so that one-half month's depreciation is allowed for the month in which the property is placed in service and for the month in which it is disposed of.
c. Depreciation will be allowed in the first year of acquisition of the property only if the property is placed in service **no** later than June 30 for calendar-year corporations.
d. Depreciation will be allowed in the last year of the property's economic life only if the property is disposed of after June 30 of the year of disposition for calendar-year corporations.

2M91#53. When a consolidated return is filed by an affiliated group of includible corporations connected from inception through the requisite stock ownership with a common parent,
a. Intercompany dividends are excludible to the extent of 80%.
b. Operating losses of one member of the group offset operating profits of other members of the group.
c. The parent's basis in the stock of its subsidiaries is unaffected by the earnings and profits of its subsidiaries.
d. Each of the subsidiaries is entitled to an accumulated earnings tax credit.

2M90

Items 29 through 34 are based on the following:

John Budd is the sole stockholder of Ral Corp., an accrual basis taxpayer engaged in wholesaling operations. Ral's retained earnings at January 1, 1989 amounted to $1,000,000. For the year ended December

31, 1989, Ral's book income, before federal income tax, was $300,000. Included in the computation of this $300,000 were the following:

Dividends received on 500 shares of stock of a taxable domestic corporation that had 1,000,000 shares of stock outstanding (Ral had no portfolio indebtedness)	$ 1,000
Loss on sale of investment in stock of unaffiliated corporation (this stock had been held for two years; Ral had no other capital gains or losses)	(5,000)
Keyman insurance premiums paid on Budd's life (Ral is the beneficiary of this policy)	3,000
Group term insurance premiums paid on $10,000 life insurance policies for each of Ral's four employees (the employees' spouses are the beneficiaries)	4,000
Amortization of cost of acquiring a perpetual dealer's franchise (Ral paid $48,000 for this franchise on July 1, 1989, and is amortizing it over a 48-month period)	6,000
Contribution to a recognized, qualified charity (this contribution was authorized by Ral's board of directors in December 1989, to be paid on January 31, 1990)	75,000

On December 1, 1989, Ral received advance rental of $27,000 from a tenant for a three-year lease commencing January 1, 1990 to cover rents for the years 1990, 1991, and 1992. In conformity with GAAP, Ral did not include any part of this rental in its income statement for the year ended December 31, 1989.

29. What portion of the dividend revenue should be included in Ral's 1989 taxable income?
   a. $150
   b. $200
   c. $300
   d. $900

30. In computing taxable income for 1989, Ral should deduct a capital loss of
   a. $0
   b. $2,500
   c. $3,000
   d. $5,000

31. What amount should Ral include in its 1989 taxable income for rent revenue?
   a. $0
   b. $ 750
   c. $ 9,000
   d. $27,000

32. What amount should Ral deduct for keyman and group life insurance premiums in computing taxable income for 1989?
   a. $0
   b. $3,000
   c. $4,000
   d. $7,000

33. What amount is deductible in Ral's 1989 return for purchase of the dealer's franchise?
   a. $0
   b. $ 600
   c. $1,200
   d. $6,000

34. With regard to Ral's contribution to the recognized, qualified charity, Ral
   a. Can elect to deduct in its 1989 return any portion of the $75,000 that does **not** exceed the deduction ceiling for 1989.
   b. Cannot deduct any portion of the $75,000 in 1989 because the contribution was **not** paid in 1989.
   c. Can deduct the entire $75,000 in its 1989 return because Ral reports on the accrual basis.
   d. Can elect to carry forward indefinitely any portion of the $75,000 **not** deducted in 1989 or 1990.

2M90#35. For the year ended December 31, 1989, Maple Corp.'s book income, before federal income tax, was $100,000. Included in this $100,000 were the following:

Provision for state income tax	$1,000
Interest earned on U.S. Treasury Bonds	6,000
Interest expense on bank loan to purchase U.S. Treasury Bonds	2,000

Maple's taxable income for 1989 was
   a. $ 96,000
   b. $ 97,000
   c. $100,000
   d. $101,000

2M90#36. In the consolidated income tax return of a corporation and its wholly-owned subsidiary, what percentage of cash dividends paid by the subsidiary to the parent is tax-free?
   a. 0%
   b. 70%
   c. 80%
   d. 100%

2N89

Items 41 through 46 are based on the following:

Kell Corp.
INCOME STATEMENT
For the Year Ended December 31, 1988

Sales		$900,000
Cost of sales		600,000
Gross margin		300,000
Operating expenses		250,000
Operating income		50,000
Other income:		
Gain on sale of investments	$15,000	
Life insurance policy proceeds	10,000	
Dividends	3,000	28,000
Total		78,000
Other expense:		
Contributions		8,000
Income before income tax		$ 70,000

41. The gain on sale of investments resulted from the sale of stock of an unrelated taxable domestic corporation. This stock had been purchased in 1980. In its 1988 income tax return, Kell should claim a long-term capital gain deduction of
   a. $0
   b. $ 6,000
   c. $ 9,000
   d. $12,000

42. The life insurance policy proceeds represent a lump-sum payment in full as a result of the death of Kell's controller. Kell was the owner and beneficiary of this policy. In its 1988 income tax return, Kell should report taxable life insurance proceeds of
   a. $10,000
   b. $ 8,000
   c. $ 5,000
   d. $0

43. The dividends were declared and received in 1988 from an unrelated taxable domestic corporation in which Kell owned less than 1% of the investee's stock. Kell had no portfolio indebtedness. In its 1988 income tax return, Kell should claim a dividends-received deduction of
   a. $0
   b. $ 100
   c. $2,100
   d. $2,400

44. All of the contributions were to qualified charitable organizations. When Kell computes the maximum allowable deduction for contributions, what percentage of contribution base income should Kell use?
   a. 50%
   b. 30%
   c. 10%
   d. 5%

45. Included in Kell's operating expenses were the following life insurance premiums:

Term life insurance premiums paid on the life of Kell's controller, with Kell as owner and beneficiary of the policy	$ 2,000
Group-term life insurance premiums paid on employees' lives, with the employees' dependents as owners and beneficiaries of the policies	18,000

In its 1988 income tax return, what amount should Kell deduct for life insurance premiums?
   a. $20,000
   b. $18,000
   c. $ 2,000
   d. $0

46. Included in Kell's operating expenses is $4,000 for depreciation of a machine that Kell purchased and placed in service in January 1988 for use in the active conduct of Kell's business. This machine cost $32,000 and has an estimated useful life of eight years, with no salvage value. No other fixed assets were acquired during 1988. Kell has taxable income and wishes to minimize its 1988 income tax to the fullest possible extent. The proper election was made in connection with the tax treatment of this machine in Kell's 1988 income tax return. Excluding normal depreciation, Kell may expense on this machine a maximum of
   a. $0
   b. $ 5,000
   c. $10,000
   d. $32,000

2N89#48. With regard to consolidated returns, which one of the following statements is correct?
   a. The common parent must directly own 51% or more of the total voting power of all corporations included in the consolidated return.
   b. Of all intercompany dividends paid by the subsidiaries to the parent, 70% are excludible from taxable income on the consolidated return.
   c. Only corporations that issue their audited financial statements on a consolidated basis may file consolidated tax returns.
   d. Operating losses of one group member may be used to offset operating profits of the other members included in the consolidated return.

2N88#22. The following information pertains to treasury stock sold by Lee Corp. to an unrelated broker in 1987:

Proceeds received	$50,000
Cost	30,000
Par value	9,000

What amount of capital gain should Lee recognize in 1987 on the sale of this treasury stock?

a. $0
b. $ 8,000
c. $20,000
d. $30,500

2N88#23. A corporation's tax preference items that must be taken into account for 1988 alternative minimum tax purposes include

a. Use of the percentage-of-completion method of accounting for long-term contracts.
b. Casualty losses.
c. Accelerated depreciation on pre-1987 real property to the extent of the excess over straight-line depreciation.
d. Capital gains.

2N88#24. In 1988, Kara Corp. incurred the following expenditures in connection with the repurchase of its stock from shareholders to avert a hostile takeover:

Interest on borrowings used to repurchase stock	$100,000
Legal and accounting fees in connection with the repurchase	400,000

The total of the above expenditures deductible in 1988 is

a. $0
b. $100,000
c. $400,000
d. $500,000

2N88#28. Dana Corp. owns stock in Seco Corp. For Dana and Seco to qualify for the filing of consolidated returns, at least what percentage of Seco's total voting power and total value of stock must be directly owned by Dana?

	Total voting power	*Total value of stock*
a.	51%	51%
b.	51%	80%
c.	80%	51%
d.	80%	80%

2M88#22. During 1987, Ral Corp. exchanged 5,000 shares of its own $10 par common stock for land with a fair market value of $75,000. As a result of this exchange, Ral should report in its 1987 tax return

a. $25,000 Section 1245 gain.
b. $25,000 Section 1231 gain.
c. $25,000 ordinary income.
d. No gain.

2M88#23. During 1987, Marb Corp. had net long-term capital losses of $7,000, net short-term capital gains of $3,000, gains of $1,500 on the sale of Section 1231 property, and losses of $2,000 on the sale of Section 1245 property. There was **no** capital loss carryforward from prior years. The capital gains deduction for 1987 was

a. $0
b. $1,000
c. $1,500
d. $4,500

2M88#24. If a corporation's charitable contributions exceed the limitation for deductibility in a particular year, the excess

a. May be carried back to the third preceding year.
b. May be carried forward to a maximum of five succeeding years.
c. May be carried back or forward for one year at the corporation's election.
d. Is **not** deductible in any future or prior year.

2M88#26. In 1987, Roe Corp. purchased and placed in service a machine to be used in its manufacturing operations. This machine cost $201,000. What portion of the cost may Roe elect to treat as an expense rather than as a capital expenditure?

a. $0
b. $ 9,000
c. $10,000
d. $20,100

2M88#27. For the year ended December 31, 1987, Dodd Corp. had net income per books of $100,000. Included in the computation of net income were the following items:

Provision for federal income tax	$27,000
Net long-term capital loss	5,000
Keyman life insurance premiums (corporation is beneficiary)	3,000

Dodd's 1987 taxable income was

a. $127,000
b. $130,000
c. $132,000
d. $135,000

2M88#28. Consolidated returns may be filed

a. Either by parent-subsidiary corporations or by brother-sister corporations.
b. Only by corporations that formally request advance permission from the IRS.
c. Only by parent-subsidiary affiliated groups.
d. Only by corporations that issue their financial statements on a consolidated basis.

B. Tax Computations and Credits

2N91#51. No penalty will be imposed on a corporation for underpayment of estimated tax for a particular year if
a. The tax for that year is less than $500.
b. Estimated tax payments for the year equal at least 80% of the tax shown on the return for that year.
c. The corporation is a personal holding company.
d. The alternative minimum tax is at least $1,000.

2M90#37. If a corporation's tentative minimum tax exceeds the regular tax, the excess amount is
a. Subtracted from the regular tax.
b. Payable in addition to the regular tax.
c. Carried back to the third preceding taxable year.
d. Carried back to the first preceding taxable year.

2N89#47. In the computation of a corporation's taxable income for a particular year, a net capital loss sustained in that year is
a. Limited to a maximum deduction of $3,000.
b. Deductible in full.
c. Deductible to a maximum extent of 50%.
d. Not deductible.

2M88#29. Except for transition property, qualified progress expenditures, and qualified timber property, the regular 10% investment tax credit
a. Is repealed for property placed in service after December 31, 1985.
b. Can be carried forward up to a maximum of 18 years.
c. Can be claimed only if the asset's estimated useful life is at least three years.
d. Is available only if the asset qualifies as five-year accelerated cost recovery system property.

C. S Corporations

2N91#57. A corporation that has been an S corporation from its inception may

	Have both passive and nonpassive income	*Be owned by a bankruptcy estate*
a.	No	Yes
b.	Yes	No
c.	No	No
d.	Yes	Yes

2M91#56. Bern Corp., an S corporation, had an ordinary loss of $36,500 for the year ended December 31, 1990. At January 1, 1990, Meyer owned 50% of Bern's stock. Meyer held the stock for 40 days in 1990 before selling the entire 50% interest to an unrelated third party. Meyer's basis for the stock was $10,000. Meyer was a full-time employee of Bern until the stock was sold. Meyer's share of Bern's 1990 loss was
a. $0
b. $ 2,000
c. $10,000
d. $18,250

2M91#57. After a corporation's status as an S corporation is revoked or terminated, how many years is the corporation required to wait before making a new S election, in the absence of IRS consent to an earlier election?
a. 1
b. 3
c. 5
d. 10

2M90#27. Which one of the following will render a corporation ineligible for S corporation status?
a. One of the stockholders is a decedent's estate.
b. One of the stockholders is a bankruptcy estate.
c. The corporation has both voting and nonvoting common stock issued and outstanding.
d. The corporation has 50 stockholders.

2N89#50. With regard to S corporations and their stockholders, the "at risk" rules applicable to losses
a. Depend on the type of income reported by the S corporation.
b. Are subject to the elections made by the S corporation's stockholders.
c. Take into consideration the S corporation's ratio of debt to equity.
d. Apply at the shareholder level rather than at the corporate level.

2N89#51. An S corporation may deduct
a. Charitable contributions within the percentage of income limitation applicable to corporations.
b. Net operating loss carryovers.
c. Foreign income taxes.
d. Compensation of officers.

2N88#25. An S corporation's accumulated adjustments account, which measures the amount of earnings that may be distributed tax-free,
a. Must be adjusted downward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
b. Must be adjusted upward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.

c. Must be adjusted upward or downward for only the federal income taxes affected by capital gains or losses, respectively, for any taxable year in which the corporation was a C corporation.
d. Is **not** adjusted for federal income taxes attributable to a taxable year in which the corporation was a C corporation.

2M88#30. To be eligible for S corporation status, a corporation can
a. Not have a decedent's estate as a stockholder.
b. Not have a bankruptcy estate as a stockholder.
c. Have both voting and nonvoting common stock issued and outstanding.
d. Not have more than 25 stockholders.

D. Personal Holding Companies

2M91#54. The following information pertains to Hull, Inc., a personal holding company, for the year ended December 31, 1990:

Undistributed personal holding company income	$100,000
Dividends paid during 1990	20,000
Consent dividends reported in the 1990 individual income tax returns of the holders of Hull's common stock, but **not** paid by Hull to its stockholders	10,000

In computing its 1990 personal holding company tax, what amount should Hull deduct for dividends paid?
a. $0
b. $10,000
c. $20,000
d. $30,000

2N89#49. Ati Corp. has two common stockholders. Ati derives all of its income from investments in stocks and securities, and it regularly distributes 51% of its taxable income as dividends to its stockholders. Ati is a
a. Personal holding company.
b. Regulated investment company.
c. Corporation subject to the accumulated earnings tax.
d. Corporation subject to tax only on income **not** distributed to stockholders.

2N88#29. Benson, a singer, owns 100% of the outstanding capital stock of Lund Corp. Lund contracted with Benson, specifying that Benson was to perform personal services for Magda Productions, Inc., in consideration of which Benson was to receive $50,000 a year from Lund. Lund contracted with Magda, specifying that Benson was to perform personal services for Magda, in consideration of which Magda was to pay Lund $1,000,000 a year. Personal holding company income will be attributable to
a. Benson only.
b. Lund only.
c. Madga only.
d. All three contracting parties.

2M88#31. The personal holding company tax
a. Qualifies as a tax credit that may be used by partners or stockholders to reduce their individual income taxes.
b. May be imposed on both corporations and partnerships.
c. Should be self-assessed by filing a separate schedule with the regular tax return.
d. May be imposed regardless of the number of equal stockholders in a corporation.

E. Accumulated Earnings Tax

2M91#42. The accumulated earnings tax can be imposed
a. Regardless of the number of stockholders of a corporation.
b. On personal holding companies.
c. On companies that make distributions in excess of accumulated earnings.
d. On both partnerships and corporations.

F. Distributions

2N89#52. How does a noncorporate shareholder treat the gain on a redemption of stock that qualifies as a partial liquidation of the distributing corporation?
a. Entirely as capital gain.
b. Entirely as a dividend.
c. Partly as capital gain and partly as a dividend.
d. As a tax-free transaction.

2N88#31. The following information pertains to Ral Corp.:

Accumulated earnings and profits at January 1, 1987	$30,000
Earnings and profits for the year ended December 31, 1987	40,000
Cash distributions to individual stockholders in 1987	90,000

What is the total amount of distributions taxable as dividend income to Ral's stockholders in 1987?
a. $0
b. $40,000
c. $70,000
d. $90,000

G. Tax-Free Incorporation

2N89#53. Rela Associates, a partnership, transferred all of its assets, with a basis of $300,000, subject to liabilities of $50,000, to a newly formed corporation in return for all of the corporation's stock. Rela then distributed this stock to the partners in liquidation. In connection with this incorporation of the partnership, Rela recognizes

a. No gain or loss on the transfer of its assets nor on the assumption of Rela's liabilities by the corporation.
b. Gain on the assumption of Rela's liabilities by the corporation.
c. Gain or loss on the transfer of its assets to the corporation.
d. Gain, but **not** loss, on the transfer of its assets to the corporation.

2M88#34. In 1987, Dr. James Pyle, a cash basis taxpayer, incorporated his dental practice. No liabilities were transferred. The following assets were transferred to the corporation:

Cash (checking account)	$1,000
Equipment	
Adjusted basis	60,000
Fair market value	68,000

Immediately after the transfer, Pyle owned 100% of the corporation's stock. The corporation's total basis for the transferred assets is

a. $69,000
b. $68,000
c. $61,000
d. $60,000

H. Reorganizations

2M91#43. Pursuant to a plan of corporate reorganization adopted in July 1990, Gow exchanged 500 shares of Lad Corp. common stock that he had bought in January 1990 at a cost of $5,000 for 100 shares of Rook Corp. common stock having a fair market value of $6,000. Gow's recognized gain on this exchange was

a. $1,000 long-term capital gain.
b. $1,000 short-term capital gain.
c. $1,000 ordinary income.
d. $0.

2N88#32. Which one of the following is a corporate reorganization as defined in the Internal Revenue Code?

a. Mere change in place of organization of one corporation.
b. Stock redemption.
c. Change in depreciation method from accelerated to straight-line.
d. Change in inventory costing method from FIFO to LIFO.

2M88#32. The accumulated earnings tax does **not** apply to

a. Corporations that have more than 100 stockholders.
b. Personal holding companies.
c. Corporations filing consolidated returns.
d. Corporations that have more than one class of stock.

I. Liquidations and Dissolutions

2M90#28. Krol Corp. distributed marketable securities in redemption of its stock in a complete liquidation. On the date of distribution, these securities had a basis of $100,000 and a fair market value of $150,000. What gain does Krol have as a result of the distribution?

a. $0.
b. $50,000 capital gain.
c. $50,000 Section 1231 gain.
d. $50,000 ordinary gain.

2N88#33. For the collapsible corporation provisions to be imposed, the holding period of the corporation's stock

a. Must be a minimum of six months.
b. Must be a minimum of 12 months.
c. Depends on the stockholder's basis for gain or loss.
d. Is irrelevant.

J. Formation of Partnership

2N91#56. Ola Associates is a limited partnership engaged in real estate development. Hoff, a civil engineer, billed Ola $40,000 in 1990 for consulting services rendered. In full settlement of this invoice, Hoff accepted a $15,000 cash payment plus the following:

	Fair market value	*Carrying amount on Ola's books*
3% limited partnership interest in Ola	$10,000	N/A
Surveying equipment	7,000	$3,000

What amount should Hoff, a cash-basis taxpayer, report in his 1990 return as income for the services rendered to Ola?

a. $15,000
b. $28,000
c. $32,000
d. $40,000

2N91#58. The following information pertains to property contributed by Gray on July 1, 1990, for a 40% interest in the capital and profits of Kag & Gray, a partnership:

As of June 30, 1990	
Adjusted basis	*Fair market value*
$24,000	$30,000

After Gray's contribution, Kag & Gray's capital totaled $150,000. What amount of gain was reportable in

Gray's 1990 return on the contribution of property to the partnership?

a. $0
b. $ 6,000
c. $30,000
d. $36,000

2N89#54. On June 1, 1988, Don Kerr received a 10% interest in the capital of Rev Company, a partnership, for services rendered. Rev's net assets at June 1 had a basis of $35,000 and a fair market value of $50,000. What income must Kerr include in his 1988 tax return for the partnership interest transferred to him by the other partners?

a. $5,000 capital gain.
b. $5,000 ordinary income.
c. $3,500 capital gain.
d. $3,500 ordinary income.

2N89#55. The following information pertains to Carr's admission to the Smith & Jones partnership on July 1, 1988:

Carr's contribution of capital: 800 shares of Ed Corp. stock bought in 1975 for $30,000; fair market value $150,000 on July 1, 1988.

Carr's interest in capital and profits of Smith & Jones: 25%.

Fair market value of net assets of Smith & Jones on July 1, 1988 after Carr's admission: $600,000.

Carr's gain in 1988 on the exchange of the Ed stock for Carr's partnership interest was

a. $120,000 ordinary income.
b. $120,000 long-term capital gain.
c. $120,000 Section 1231 gain.
d. $0.

2M88#33. In 1987, Dave Burr acquired a 20% interest in a partnership by contributing a parcel of land. At the time of Burr's contribution, the land had a fair market value of $35,000, an adjusted basis to Burr of $8,000, and was subject to a mortgage of $12,000. Payment of the mortgage was assumed by the partnership. Burr's basis for his interest in the partnership is

a. $0
b. $ 5,600
c. $ 8,000
d. $23,000

2M88#35. On December 31, 1987, Gail Raff received a 10% interest in the capital of Cole & Co., a partnership, for past services rendered. Cole's net assets at December 31 had a basis of $70,000 and a fair market value of $100,000. How much ordinary income should Gail include in her 1987 return for the partnership interest transferred to her by the other partners?

a. $0
b. $ 3,000
c. $ 7,000
d. $10,000

K. Basis of Partner's Interest

2N91#59. Which of the following should be used in computing the basis of a partner's interest acquired from another partner?

	Cash paid by transferee to transferor	*Transferee's share of partnership liabilities*
a.	No	Yes
b.	Yes	No
c.	No	No
d.	Yes	Yes

2N91#60. The holding period of a partnership interest acquired in exchange for a contributed capital asset begins on the date

a. The partner is admitted to the partnership.
b. The partner transfers the asset to the partnership.
c. The partner's holding period of the capital asset began.
d. The partner is first credited with the proportionate share of partnership capital.

2M91#58. Eng contributed the following assets to a partnership in exchange for a 50% interest in the partnership's capital and profits:

Cash	$50,000
Equipment:	
Fair market value	35,000
Carrying amount (adjusted basis)	25,000

The basis for Eng's interest in the partnership is

a. $37,500
b. $42,500
c. $75,000
d. $85,000

2N88#34. The following information pertains to land contributed by Pink for a 50% interest in a new partnership:

Adjusted basis to Pink	$100,000
Fair market value	300,000
Mortgage assumed by partnership	30,000

The basis for Pink's partnership interest is

a. $ 70,000
b. $ 85,000
c. $100,000
d. $300,000

2N88#35. On July 1, 1987, in exchange for past services rendered, Eng received a 5% interest in the capital of State Associates, a partnership. State's net assets at July 1, 1987, had a basis of $200,000 and a fair market value of $300,000. What amount of ordinary income should Eng include in his 1987 return for the partnership interest transferred to him by the other partners?

a. $ 5,000
b. $ 7,500
c. $10,000
d. $15,000

2N88#36. The holding period of property acquired by a partnership as a contribution to the contributing partner's capital account

a. Begins with the date of contribution to the partnership.
b. Includes the period during which the property was held by the contributing partner.
c. Is equal to the contributing partner's holding period prior to contribution to the partnership.
d. Depends on the character of the property transferred.

L. Determination of Partner's Taxable Income and Partner's Elections

2N91#55. Which of the following limitations will apply in determining a partner's deduction for that partner's share of partnership losses?

	At-risk	*Passive loss*
a.	Yes	No
b.	No	Yes
c.	Yes	Yes
d.	No	No

2M90#24. Dale's distributive share of income from the calendar-year partnership of Dale & Eck was $50,000 in 1989. On December 15, 1989, Dale, who is a cash-basis taxpayer, received a $27,000 distribution of the partnership's 1989 income, with the $23,000 balance paid to Dale in May 1990. In addition, Dale received a $10,000 interest-free loan from the partnership in 1989. This $10,000 is to be offset against Dale's share of 1990 partnership income. What total amount of partnership income is taxable to Dale in 1989?

a. $27,000
b. $37,000
c. $50,000
d. $60,000

2M88#36. Dunn and Shaw are partners who share profits and losses equally. In the computation of the partnership's 1987 book income of $100,000, guaranteed payments to partners totaling $60,000 and charitable contributions totaling $1,000 were treated as expenses. What amount should be reported as ordinary income on the partnership's 1987 return?

a. $100,000
b. $101,000
c. $160,000
d. $161,000

M. Accounting Periods of Partnership and Partners

2M90#25. Which one of the following statements regarding a partnership's tax year is correct?

a. A partnership formed on July 1 is required to adopt a tax year ending on June 30.
b. A partnership may elect to have a tax year other than the generally required tax year if the deferral period for the tax year elected does **not** exceed three months.
c. A "valid business purpose" can **no** longer be claimed as a reason for adoption of a tax year other than the generally required tax year.
d. Within 30 days after a partnership has established a tax year, a form must be filed with the IRS as notification of the tax year adopted.

N. Partner Dealing With Own Partnership

2M91#59. Under the Internal Revenue Code sections pertaining to partnerships, guaranteed payments are payments to partners for

a. Payments of principal on secured notes honored at maturity.
b. Timely payments of periodic interest on bona fide loans that are **not** treated as partners' capital.
c. Services or the use of capital without regard to partnership income.
d. Sales of partners' assets to the partnership at guaranteed amounts regardless of market values.

2N89#56. Doris and Lydia are equal partners in the capital and profits of Agee & Nolan, but are otherwise unrelated. The following information pertains to 300 shares of Mast Corp. stock sold by Lydia to Agee & Nolan:

Year of purchase	1980
Year of sale	1988
Basis (cost)	$9,000
Sales price (equal to fair market value)	$4,000

The amount of long-term capital loss that Lydia realized in 1988 on the sale of this stock was

a. $5,000
b. $3,000
c. $2,500
d. $0

2N88#37. In the computation of the ordinary income of a partnership, a deduction is allowed for

a. Contributions to qualified charities.
b. The net operating loss deduction.
c. Guaranteed payments to partners.
d. Short-term and long-term capital losses.

O. Treatment of Liabilities

2M91#60. Beck and Nilo are equal partners in B&N Associates, a general partnership. B&N borrowed $10,000 from a bank on an unsecured note, thereby increasing each partner's share of partnership liabilities. As a result of this loan, the basis of each partner's interest in B&N was

a. Increased.
b. Decreased.
c. Unaffected.
d. Dependent on each partner's ability to meet the obligation if called upon to do so.

P. Distribution of Partnership Assets

2N91#54. The basis to a partner of property distributed "in kind" in complete liquidation of the partner's interest is the

a. Adjusted basis of the partner's interest increased by any cash distributed to the partner in the same transaction.
b. Adjusted basis of the partner's interest reduced by any cash distributed to the partner in the same transaction.
c. Adjusted basis of the property to the partnership.
d. Fair market value of the property.

2M90#26. Hart's adjusted basis of his interest in a partnership was $30,000. He received a nonliquidating distribution of $24,000 cash plus a parcel of land with a fair market value and partnership basis of $9,000. Hart's basis for the land is

a. $9,000
b. $6,000
c. $3,000
d. $0

Q. Termination of Partnership

2M90#21. Partnership Abel, Benz, Clark & Day is in the real estate and insurance business. Abel owns a 40% interest in the capital and profits of the partnership, while Benz, Clark, and Day each owns a 20% interest. All use a calendar year. At November 1, 1989, the real estate and insurance business is separated, and two partnerships are formed: Partnership Abel & Benz takes over the real estate business, and Partnership Clark & Day takes over the insurance business. Which one of the following statements is correct for tax purposes?

a. Partnership Abel & Benz is considered to be a continuation of Partnership Abel, Benz, Clark & Day.
b. In forming Partnership Clark & Day, partners Clark and Day are subject to a penalty surtax if they contribute their entire distributions from Partnership Abel, Benz, Clark & Day.
c. Before separating the two businesses into two distinct entities, the partners must obtain approval from the IRS.
d. Before separating the two businesses into two distinct entities, Partnership Abel, Benz, Clark & Day must file a formal dissolution with the IRS on the prescribed form.

2M90
Items 22 and 23 are based on the following:

The personal service partnership of Allen, Baker & Carr had the following cash basis balance sheet at December 31, 1989:

Assets

	Adjusted basis per books	*Market value*
Cash	$102,000	$102,000
Unrealized accounts receivable	—	420,000
Totals	$102,000	$522,000

Liability and Capital

Note payable	$ 60,000	$ 60,000
Capital accounts:		
Allen	14,000	154,000
Baker	14,000	154,000
Carr	14,000	154,000
Totals	$102,000	$522,000

Carr, an equal partner, sold his partnership interest to Dole, an outsider, for $154,000 cash on January 1, 1990. In addition, Dole assumed Carr's share of the partnership's liability.

22. What was the total amount realized by Carr on the sale of his partnership interest?

a. $174,000
b. $154,000
c. $140,000
d. $134,000

23. What amount of ordinary income should Carr report in his 1990 income tax return on the sale of his partnership interest?

a. $0
b. $ 20,000
c. $ 34,000
d. $140,000

2M88#37. On November 1, 1987, Kerry and Payne, each of whom was a 20% partner in the calendar-year partnership of Roe Co., sold their partnership interests to Reed, who was a 60% partner. For tax purposes, the Roe Co. partnership

a. Was terminated as of November 1, 1987.
b. Was terminated as of December 31, 1987.
c. Continues in effect until a formal partnership dissolution notice is filed with the IRS.
d. Continues in effect until a formal partnership dissolution resolution is filed in the office of the county clerk where Roe Co. had been doing business.

R. Types of Organizations

2M90#39. The private foundation status of an exempt organization will terminate if it

a. Is governed by a charter that limits the organization's exempt purposes.
b. Does **not** distribute all of its net assets to one or more public charities.
c. Is a foreign corporation.
d. Becomes a public charity.

2N89#58. Which one of the following types of organizations qualifies as an organization exempt from income tax?

a. An "action" organization established for the purpose of influencing legislation pertaining to protection of animal rights.
b. All "feeder" organizations, primarily conducting businesses for profit, but distributing 100% of their profits to organizations exempt from income tax.
c. A social club organized and operated exclusively for the pleasure and recreation of its members, supported solely by membership fees, dues, and assessments.
d. An organization whose purpose is to foster national or international amateur sports competition by providing athletic facilities and equipment.

2N88#38. Carita Fund, organized and operated exclusively for charitable purposes, provides insurance coverage, at amounts substantially below cost, to exempt organizations involved in the prevention of cruelty to children. Carita's insurance activities are

a. Exempt from tax.
b. Treated as unrelated business income.
c. Subject to the same tax provisions as those applicable to insurance companies.
d. Considered "commercial-type" as defined by the Internal Revenue Code.

2M88#39. A condominium management association wishing to be treated as a homeowners association and to qualify as an exempt organization for a particular year

a. Need **not** file a formal election.
b. Must file an election as of the date the association was organized.
c. Must file an election at the beginning of the association's first taxable year.
d. Must file a separate election for each taxable year no later than the due date of the return for which the election is to apply.

S. Requirements for Exemption

2N91#53. Which of the following exempt organizations must file annual information returns?

a. Those with gross receipts of less than $5,000 in each taxable year.
b. Private foundations.
c. Internally supported auxiliaries of churches.
d. Churches.

2M90#40. To qualify as an exempt organization, the applicant

a. May be organized and operated for the primary purpose of carrying on a business for profit, provided that all of the organization's net earnings are turned over to one or more tax exempt organizations.
b. Need **not** be specifically identified as one of the classes upon which exemption is conferred by the Internal Revenue Code, provided that the organization's purposes and activities are of a nonprofit nature.
c. Must **not** be classified as a social club.
d. Must **not** be a private foundation organized and operated exclusively to influence legislation pertaining to protection of the environment.

2N89#59. To qualify as an exempt organization other than an employees' qualified pension or profit-sharing trust, the applicant

a. Is barred from incorporating and issuing capital stock.
b. Must file a written application with the Internal Revenue Service.
c. Cannot operate under the "lodge system" under which payments are made to its members for sick benefits.
d. Need **not** be specifically identified as one of the classes on which exemption is conferred by the Internal Revenue Code, provided that the organization's purposes and activities are of a nonprofit nature.

2M88#40. An organization wishing to qualify as an exempt organization

a. Is prohibited from issuing capital stock.
b. Is limited to three prohibited transactions a year.
c. Must **not** have non-U.S. citizens on its governing board.
d. Must be of a type specifically identified as one of the classes on which exemption is conferred by the Code.

T. Unrelated Business Income

2M91#41. Salud Welfare Associates is an exempt organization that operates under a corporate charter granted by the state in which Salud's principal office is located. Salud's tax on unrelated business taxable income is

a. Abated.
b. Credited against the tax on recognized capital gains.
c. Computed at rates applicable to trusts.
d. Computed at corporate income tax rates.

2M90#38. An incorporated exempt organization subject to tax on its 1989 unrelated business income

a. Must make estimated tax payments if its tax can reasonably be expected to be $100 or more.
b. Must comply with the Code provisions regarding installment payments of estimated income tax by corporations.
c. Must pay at least 70% of the tax due as shown on the return when filed, with the balance of tax payable in the following quarter.
d. May defer payment of the tax for up to nine months following the due date of the return.

2N89#60. With regard to unrelated business income of an exempt organization, which one of the following statements is correct?

a. An unrelated trade or business activity that results in a loss is excluded from the definition of unrelated business.
b. The tax on unrelated business income can be imposed even if the unrelated business activity is intermittent and is carried on once a year.
c. An exempt organization is **not** taxed on unrelated business income of less than $1,000.
d. An exempt organization that earns any unrelated business income in excess of $100,000 during a particular year will lose its exempt status for that particular year.

2N88#40. The filing of a return covering unrelated business income

a. Is required of all exempt organizations having at least $1,000 of unrelated business taxable income for the year.
b. Relieves the organization of having to file a separate annual information return.
c. Is **not** necessary if all of the organization's income is used exclusively for charitable purposes.
d. Must be accompanied by a minimum payment of 50% of the tax due as shown on the return, with the balance of tax payable six months later.

2M88#38. An exempt organization subject to tax on its 1988 unrelated business income

a. Must comply with the Code provisions regarding installment payments of estimated income tax by corporations.
b. Must pay at least 50% of the tax due as shown on the return when filed, with the balance of tax payable six months later.
c. May defer payment of the tax for up to nine months following the due date of the return.
d. May elect to make installment payments of estimated tax but is **not** required to do so.

SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1N91# 1 d
1M91# 1 a
1M91# 2 a
1M89# 1 d
1M89# 2 d
1M89# 3 a
1M89# 4 c

B. Income Statement

1M91# 3 d
1M91# 5 d
1N89# 1 c
1N89# 2 a
1N88# 7 d
1N88# 8 c
1N88# 9 a

C. Statement of Cash Flows

1N91# 5 c
1N91# 6 a
1N91# 7 d
1M91# 4 c
1M91# 6 c
1M91# 8 c
1M91# 9 d
1M91#10 a
1M91#11 d
1M89# 5 c
1M89# 6 a
1M89# 7 a
1M89# 9 b
1M89#10 a or b
1M89#16 c
1M89#17 b

D. Statement of Owners' Equity

1M92# 1 d
1M92# 2 d
1M92# 3 a
1M92# 5 a
1M91#18 b
1M91#19 a
1M91#20 d
1N89# 3 c
1M89#13 c
1M89#14 d
1M89#18 a

E. Consolidated Financial Statements or Worksheets

1M92# 4 a
1M92# 6 c
1M92# 7 a
1M92# 8 d
1M92# 9 b
1M92#11 c
1M91# 7 a
1M91#13 a
1M91#14 b
1M91#15 d
1M91#16 b
1M91#17 b
1N89# 5 b
1N89# 6 b
1N89# 7 a
1N89# 8 d
1N89# 10 d
1N89# 11 a
1M89#55 c
1M89#56 b
1M89#57 b
1M89#58 c
1N88# 2 a
1N88# 3 c
1N88# 4 b
1N88# 5 b
1N88# 6 a
1M88#10 b
1M88#11 a
1M88#13 a
1M88#14 b
1M88#15 c
1M88#16 c
1M88#17 c

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

1M92#12 c
1M92#13 c
1M92#14 a
1N91# 3 c
1N91# 8 b
1N91# 9 c
1N90# 1 a
1N90# 2 d
1N90# 3 b
1N90# 4 d
1M90# 1 a
1M90# 2 d
1M90# 3 b
1M90# 4 a
1M90# 7 b
2N89# 1 a
2N89# 2 b
2N89# 3 d
2N89# 4 d
1N88# 1 c
1N88# 15 d
1M88# 1 b
1M88#12 c
1M88#18 c

B. Receivables and Accruals

1M92#10 a
1M92#15 d
1M92#16 c
1M92#21 c
1N91# 10 d
1N91# 11 b
1N91# 17 c
1N90# 5 a
1N90# 6 b
2N90# 1 d
2N90# 3 c
2N90# 9 a
1M90# 5 a
1M90# 9 d
1M90#10 c
1M90#11 d
1M90#12 a
1M90#17 b
2N89# 5 c
2N89# 6 a
2N89# 7 a
2N89# 8 a
1M89# 8 d
1M89#15 c
1N88# 10 a
1N88# 16 c
1N88# 18 b
1M88#20 b

C. Inventories

1M92#17 d
1M92#18 b
1N91# 12 d
1N91# 13 c
1M91#21 b
1N90# 7 c
1N90# 8 c
1M90#13 a
1M90#14 b
2N89# 10 c
1M89#21 b
1M89#22 d
1N88# 17 d
1M88#21 d
1M88#22 c

D. Property, Plant, and Equipment Owned or Leased

1M92#19 b
1M92#22 a
1N91# 14 b
1N91# 15 d
1N91# 16 a

1N91# 18 b
1N91# 19 a
1M91#23 d
1M91#24 c
1M91#25 b
1M91#26 d
1M91#27 b
2N90# 2 d
2N90# 4 a
2N90# 5 b
2N90# 13 a
1M90#15 c
1M90#16 d
1M90#18 b
1M90#19 b
1M89#23 b
1M89#25 a
1M89#26 c
1M89#27 b
1M88#23 b
1M88#24 a
1M88#25 c

E. Intangibles and Other Assets

1M92#20 c
1M92#23 c
1M92#24 b
1N91# 4 a
1N91# 20 d
1M91#22 c
1M91#28 d
1M91#29 b
1M91#30 d
1M91#32 c
1N90# 9 a
2N90# 14 c
2N90# 17 b
2N90# 19 a
1M90#20 b
1M90#21 b
1N89# 12 a
1N89# 13 a
1M89#28 a
1M89#29 a
1N88# 11 b
1N88# 12 b
1N88# 23 d
1M88#26 b
1M88#27 c

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals

1M92#25 d
1M92#26 c
1N91# 21 c
1N91# 22 c
1N91# 23 c
1N91# 25 b
1N91# 26 b
1M91#33 b
1M91#34 a
1M91#35 c
1M91#36 b
1M91#37 d
1M91#38 c
1M91#39 b
1N90# 10 b
1N90# 11 d
1N90# 12 d
1N90# 13 c
1N90# 14 b
1N90# 15 d
1N90# 16 a
1M90#22 c
1M90#23 d
1M90#26 a
1M90#27 d
1M90#29 a
1M90#30 c
1N89# 15 d
1N89# 16 c
1N89# 17 a
1N89# 18 c
1N89# 19 d
1N89# 20 a
1N89# 21 d
1M89#24 b
1M89#30 c
1M89#32 d
1M89#35 c
1M89#36 c
1M89#38 d
1N88# 13 a
1M88#28 b
1M88#29 c
1M88#30 b

B. Deferred Revenues

1M92#27 a
1M92#28 d
1M92#31 a
1N91# 27 c
1N91# 29 d
1M91#40 d
1M91#43 c
1M91#44 b
1N90# 17 b
1N90# 18 c
1M90#31 d
1N89# 23 c
1M89#34 b
1M89#39 c
1N88# 20 d
1N88# 21 b
1M88#32 c

C. Deferred Income Tax Liabilities

1M92#32 b
1M92#33 c
1N91# 30 b
1N91# 32 d
1N91# 35 b
1N91# 38 c
1M91#41 d
1N90# 19 a
1N90# 20 a
1M90#28 b
1M90#32 a
1M90#34 c
1N89# 24 c
1N89# 26 b
1M89#37 c
1M89#40 d
1M89#41 d
1M89#42 a

D. Capitalized Lease Liability

1M92#34 c
1N91# 33 b
1N91# 34 b
1M91#42 a
1M91#45 b
1N90# 21 a
1N90# 22 d
1M90#33 c
1M90#35 b
1N89# 22 d
1N89# 27 b
1M89#44 b
1N88# 22 a
1N88# 29 c
1M88#35 d

E. Bonds Payable

1M92#29 b
1M92#30 c
1N91# 24 d
1N91# 28 a
1N91# 36 d
1N91# 37 a
1M91#46 d
1M91#47 a
1N90# 23 d
1N90# 24 b
1N90# 25 b
1N90# 26 b
1N90# 27 c
1M90#36 a
1M90#37 a
1M90#38 b
1M90#40 d
1M90#42 c
1N89# 25 c
1N89# 28 b
1N89# 29 c
1N89# 30 a
1N89# 31 b
1M89#45 d
1M89#47 c
1M89#49 b
1N88# 32 a
1M88#37 c
1M88#38 d
1M88#39 b

F. Contingent Liabilities and Commitments

1M92#35 d
1M92#36 b
1N91# 39 d
1N90# 28 c
1M90#59 a
1M90#60 c
1N89# 32 a
1N89# 33 c
1M89#43 b
1N88# 25 b
1M88#41 c

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock

2M92# 1 c
2N91# 1 a
2N91# 3 d
2M91# 4 a
2N89# 11 d
2N89# 12 c
1N88# 48 c
1M88#42 b

B. Additional Paid-in Capital

2M91# 6 d
1N88# 28 a

C. Retained Earnings and Dividends

2M92# 2 c
2M92# 3 d
2M92# 4 c
2M92# 5 a
2M92# 6 a
2N91# 2 a
2N91# 4 c
2N91# 5 c
2N91# 6 d
2M91# 7 a
2M91#12 b
1N90# 29 c
2N89# 13 d
2N89# 14 c
2N89# 15 b
2M89# 3 d
1N88# 60 d
1M88#43 b

D. Treasury Stock and Other Contra Accounts

2M92# 7 c
2N91# 7 c
2M89# 6 c
1N88# 44 d

E. Stock Options, Warrants, and Rights

2M92# 8 a
2M91# 5 b
2M89# 7 c
1N88# 41 a

F. Reorganization and Change in Entity

2M92# 9 b
2M92#10 d
2N91# 8 d
2N91# 10 d
2M91#13 c
2M91#14 c
1N90# 31 d
2N89# 18 b
1N88# 56 b
1M88#44 c

G. Partnerships

2N91# 11 c
2M91# 1 d
2M91# 2 c
2M91# 3 b
2N89# 17 a
2N89# 19 b
2N89# 20 b
2M89# 5 a
2M89# 9 a
2M89#10 a
1N88# 26 c
1N88# 27 b

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

A. Revenues and Gains

1M92#37 b
1M92#38 a
1M92#39 d
1M92#40 b
1M92#41 c
1M92#43 a
1M92#44 b
1M92#45 b
1M92#46 c
1N91# 31 c
1N91# 40 a
1N91# 41 c
1N91# 42 a
1N91# 43 d
1N91# 44 a
1N91# 46 d
1N91# 49 c
1N91# 52 c
1N91# 58 b
1M91#48 d
1M91#49 a
1M91#50 d
1M91#52 c
1M91#53 a
1N90# 32 a
1N90# 33 a
1N90# 34 c
1N90# 35 c
1N90# 36 d
1N90# 37 a
1N90# 38 c
1N90# 39 b
2N90# 6 c
2N90# 15 d
2N90# 20 d
1M90# 6 c
1M90# 8 c
1M90#44 d
1M90#45 a
1M90#46 d
1M90#47 d
1M90#48 c
2M90#41 d
2M90#44 c
2M90#45 b
2M90#57 c
1N89# 34 b
1N89# 35 a
1N89# 36 b
1N89# 37 c
1N89# 38 b
1N89# 39 d
1N89# 40 d
1N89# 41 c
1N89# 43 b
1N89# 44 a
1M89#11 a
1M89#50 c
1M89#51 d
1M89#53 b
1M89#54 b
1M89#59 c
1N88# 31 d
1N88# 33 c
1N88# 34 d
1N88# 35 d
1N88# 36 d
1N88# 37 a
1N88# 38 a
1N88# 40 a
1N88# 42 d
1M88#45 d

B. Expenses and Losses

1M92#47 a
1M92#48 b
1M92#49 d
1M92#50 b
1M92#51 c
1M92#52 a
1M92#53 d
1M92#54 a
1M92#55 d
1N91# 47 b
1N91# 50 c
1N91# 53 d
1N91# 54 a
1N91# 55 a
1N91# 57 c
1M91#51 c
1M91#54 b
1M91#55 c
1M91#56 a
1M91#57 c
1M91#58 c
1N90# 40 a
1N90# 41 c
1N90# 42 d
1N90# 43 d
1N90# 44 b
1N90# 45 d
1N90# 46 b
1N90# 47 a
2N90# 8 d
2N90# 10 a
2N90# 11 d
2N90# 12 c
1M90#49 b
1M90#50 d
1M90#51 d
1M90#52 a
1M90#53 c
1M90#54 d
1M90#55 c
1M90#56 c

1M90#57 a
1M90#58 b
2M90#42 a
2M90#46 a
2M90#48 d
2M90#49 a
1N89# 42 b
1N89# 45 c
1M89#12 a
1M89#19 b
1M89#20 c
1M89#48 c
1N88# 43 b
1M88#48 a
1M88#51 d
1M88#52 c

C. Provision for Income Tax

1M92#56 a
1N91# 48 b
1N91# 59 a
1N90# 48 c
2N90# 7 b
1M90#39 c
1M90#41 a

D. Recurring Versus Nonrecurring Transactions and Events

1M92#57 c
1M92#58 b
1N91# 45 d
1N91# 51 a
1N90# 49 a
1N90# 50 a
2M90#47 a
1N89# 46 a
1N89# 50 b
1M89#60 d
1N88# 45 d
1N88# 47 b

E. Accounting Changes

1N91# 56 a
1M91#59 d
1M91#60 b
1N90# 51 a
1N89# 51 c
1N89# 52 b
1M89#52 a

F. Earnings Per Share

1M92#59 d
1M92#60 b
1N91# 60 b
1N90# 52 b
2M90#51 b
1N89# 54 b
1N88# 50 a
1N88# 57 d

VI. Other Financial Topics

A. Disclosures in Notes to the Financial Statements

2N91# 13 a
1N90# 53 c
1N90# 54 d
1N89# 53 c
2M89#16 c
1N88# 51 c
1M88#46 d

C. Nonmonetary Transactions

2M92#11 b
2N91# 9 b
2N90# 18 c
2M90#58 c
1M88#50 b

D. Interim Financial Statements

2M92#12 b
1N90# 55 b
2M90#43 d
1N89# 49 d
2M89#12 c
1N88# 46 a

E. Historical Cost, Constant Dollar Accounting, and Current Cost

2M92#13 d
2M90#50 b
1N89# 59 b
2M89#13 b
1N88# 52 a
1M88#55 d

F. Gain Contingencies

2M91#15 d
1N90# 56 d
2M90#60 a
1N89# 60 d
1N88# 53 a
1M88#56 d

G. Segments and Lines of Business

2N91# 12 b
2M91#11 b
2M91#16 c
2M90#54 c
2M90#56 c

H. Employee Benefits

2M92#14 d
2M92#15 b
2N91# 20 c
2M91#17 b
2N90# 16 d
2M90#53 c
1N89# 56 a
2M89#19 b

I. Analysis of Financial Statements

2M92#16 d
2M92#17 a
2M92#18 a
2N91# 18 b
2N91# 19 b
2M91#18 d
1N90# 57 b
2M90#55 a
1N89# 57 c
2M89#14 b
2M89#15 d
1N88# 49 d
1M88#57 a

J. Development Stage Enterprises

1N90# 58 a
2M90#52 d
1N89# 4 d
1N88# 55 d
1M88#58 a
1M88#59 c

K. Personal Financial Statements

2M92#19 d
2N91# 14 b
2N91# 15 a
2N91# 16 c
2M91# 8 a
2M91# 9 d
2M91#10 a
1N90# 59 d
2M90#59 a
1N89# 58 d
2M89#17 d
1N88# 59 b
1M88#60 a

L. Combined Financial Statements

2M92#20 b
2N91# 17 a
2M91#19 c
2M91#20 a
1N90# 60 c
1N89# 55 c
1N88# 58 d
1M88#53 b

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

2M92#41 d
2M92#42 d
2M92#43 a
2N89# 33 d
2N89# 34 b
2N89# 35 d

B. Process and Job Order Costing

2M92#44 b
2M92#45 a

C. Standard Costing

2M92#46 a
2N89# 26 d

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

2M92#47 a
2M92#48 b
2N89# 32 c

E. Absorption and Variable Costing

2M92#49 b
2N89# 29 d
2N89# 30 a

F. Budgeting and Flexible Budgeting

2N89# 31 a

G. Breakeven and Cost-Volume-Profit Analysis

2M92#50 a
2N89# 27 b

H. Capital Budgeting Techniques

2M92#57 d
2M92#58 d
2M92#59 d
2M92#60 c
2N89# 36 b
2N89# 40 b

I. Performance Analysis

2M92#51 a
2M92#52 a
2M92#53 b
2N89# 37 a
2N89# 38 c

J. Other

2M92#54 b
2M92#55 c
2M92#56 c
2N89# 21 c
2N89# 22 c
2N89# 23 c
2N89# 25 a

VIII. Not-for-Profit and Governmental Accounting

A. Fund Accounting

2M92#21 b
2M92#22 d
2M92#23 c
2M92#24 a
2M92#25 c
2N90# 46 b
2N90# 50 a
2N90# 51 d
2N90# 54 b
2N90# 55 b
2N90# 56 c
2N90# 57 d
2M89#21 c
2M89#22 a
2M89#23 c
2M89#24 c
2M89#25 d
2M89#26 b
2M88#44 b
2M88#45 a
2M88#46 d
2M88#47 c
2M88#48 b
2M88#49 c
2M88#50 d

B. Types of Funds and Fund Accounts

2M92#27 b
2M92#28 a
2M92#29 c
2M92#30 c
2M92#31 d
2M92#32 d
2M92#33 a
2M92#34 c
2M92#35 c
2M92#36 d
2M92#37 a
2N90# 41 a
2N90# 42 d
2N90# 43 d
2N90# 44 c
2N90# 45 a
2N90# 47 c
2N90# 48 a
2N90# 49 b
2N90# 52 c
2N90# 53 a
2M90# 1 c
2M90# 2 d
2M90# 3 c
2M90# 4 a
2M90# 5 d
2M90# 6 c
2M90# 7 a
2M90# 8 b
2M90#10 d
2M90#14 b
2M90#15 c
2M89#28 a
2M89#39 b
2N88# 42 c
2N88# 43 d
2N88# 44 c
2N88# 45 b
2N88# 46 d
2N88# 47 c
2N88# 48 c
2N88# 49 c
2N88# 51 b
2N88# 52 c
2M88#41 d
2M88#43 c

C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

2N90# 58 d
2N90# 59 d
2N90# 60 a
2M90# 9 c
2M90#16 b
2M90#19 b

D. Various Types of Not-for-Profit and Governmental Organizations

2M92#38 d
2M92#40 b
2M90#11 a
2M90#13 b
2M90#17 b
2M90#18 a
2M90#20 c
2M89#29 a
2M89#30 d
2M89#31 d
2M89#32 c
2M89#33 c
2M89#36 b
2M89#37 d
2M89#38 b
2N88# 53 b
2N88# 54 a
2N88# 56 d
2N88# 57 d
2N88# 58 b
2N88# 59 a
2N88# 60 a
2M88#51 d
2M88#52 a
2M88#53 c
2M88#54 a
2M88#56 c
2M88#57 d
2M88#58 b
2M88#59 c
2M88#60 a

IX. Federal Taxation — Individuals, Estates, and Trusts

A. Inclusions for Gross Income and Adjusted Gross Income

2N91# 28 d
2N91# 30 a
2N91# 31 b
2M91#21 a
2M91#22 a
2M91#23 d
2M91#24 b
2M91#28 a
2N90# 25 a
2N90# 26 c
2N90# 27 c
2M89#44 a
2M89#45 c
2M89#54 a
2N88# 2 d
2N88# 3 b
2N88# 5 d
2N88# 6 a
2N88# 7 c
2N88# 8 b
2N88# 9 d
2M88# 1 a
2M88# 2 d
2M88# 3 d
2M88# 4 b
2M88# 5 a
2M88# 6 d
2M88# 9 a

B. Exclusions and Adjustments to Arrive at Adjusted Gross Income

2N91# 32 a
2M89#46 c
2N88# 10 d
2N88# 11 a
2M88#15 c

C. Gain or Loss on Property Transactions

2N91# 33 b
2N90# 28 b
2N90# 29 d
2N90# 30 c
2M89#41 b
2M89#42 a
2M89#52 b

D. Deductions From Adjusted Gross Income

2N91# 21 c
2N91# 34 b
2N91# 35 d
2N91# 36 d
2M91#26 c
2M91#27 d
2M91#29 a
2M91#30 a
2M91#31 d
2M91#32 d
2N90# 31 b
2N90# 32 d
2N90# 33 c
2N90# 34 c
2M89#48 d
2M89#49 b
2M89#50 b
2M89#51 b
2N88# 13 a
2N88# 15 b
2M88# 7 b
2M88#12 d
2M88#13 c
2M88#14 a

E. Filing Status and Exemptions

2M91#34 b
2N90# 24 a
2M89#43 a
2N88# 16 c
2M88#11 a

F. Tax Computations and Credits

2N91# 22 a
2M91#33 c
2N90# 23 c
2M89#47 a
2M88# 8 d

G. Statute of Limitations

2N90# 21 b
2N90# 22 a
2M89#56 d

H. Estate and Gift Taxation and Income Taxation of Estates and Trusts

2N91# 23 a
2N91# 24 a
2N91# 25 d
2N91# 26 d
2N91# 27 a
2N91# 37 c
2N91# 38 c
2N91# 39 c
2N91# 40 c
2M91#35 a
2M91#36 d
2M91#37 c
2M91#38 c
2M91#39 c
2M91#40 b
2N90# 35 b
2N90# 36 b
2N90# 37 d
2N90# 38 b
2N90# 39 a
2N90# 40 a
2M89#58 a
2M89#59 a
2M89#60 d
2N88# 17 c
2N88# 18 c
2N88# 19 d
2N88# 20 b
2M88#17 c
2M88#18 b
2M88#19 b
2M88#20 c

X. Federal Taxation—Corporations, Partnerships, and Exempt Organizations

A. Determination of Taxable Income or Loss

2N91# 41 d
2N91# 42 a
2N91# 44 d
2N91# 45 d
2N91# 46 b
2N91# 47 d
2N91# 48 c
2N91# 49 b
2N91# 50 a
2M91#44 c
2M91#45 b
2M91#46 a
2M91#47 b
2M91#49 a
2M91#50 b
2M91#51 d
2M91#52 a
2M91#53 b
2M90#29 c
2M90#30 a
2M90#31 d
2M90#32 c
2M90#33 a
2M90#34 a
2M90#35 c
2M90#36 d
2N89# 41 a
2N89# 42 d
2N89# 43 c
2N89# 44 c
2N89# 45 b
2N89# 46 c
2N89# 48 d
2N88# 22 a
2N88# 23 c
2N88# 24 b
2N88# 28 d
2M88#22 d
2M88#23 a
2M88#24 b
2M88#26 b
2M88#27 d
2M88#28 c

B. Tax Computations and Credits

2N91# 51 a
2M90#37 b
2N89# 47 d
2M88#29 a

C. S Corporations

2N91# 57 d
2M91#56 b
2M91#57 c
2M90#27 d
2N89# 50 d
2N89# 51 d
2N88# 25 d
2M88#30 c

D. Personal Holding Companies

2M91#54 d
2N89# 49 a

2N88# 29 b
2M88#31 c

E. Accumulated Earnings Tax

2M91#42 a

F. Distributions

2N89# 52 a
2N88# 31 c

G. Tax-Free Incorporation

2N89# 53 a
2M88#34 c

H. Reorganizations

2M91#43 d
2N88# 32 a
2M88#32 b

I. Liquidations and Dissolutions

2M90#28 b
2N88# 33 d

J. Formation of Partnership

2N91# 56 c
2N91# 58 a
2N89# 54 b
2N89# 55 d
2M88#33 a
2M88#35 d

K. Basis of Partner's Interest

2N91# 59 d
2N91# 60 c
2M91#58 c
2N88# 34 b
2N88# 35 d
2N88# 36 b

L. Determination of Partner's Taxable Income and Partner's Elections

2N91# 55 c
2M90#24 c
2M88#36 b

M. Accounting Periods of Partnership and Partners

2M90#25 b

N. Partner Dealing With Own Partnership

2M91#59 c
2N89# 56 a
2N88# 37 c

O. Treatment of Liabilities

2M91#60 a

P. Distribution of Partnership Assets

2N91# 54 b
2M90#26 b

Q. Termination of Partnership

2M90#21 a
2M90#22 a
2M90#23 d
2M88#37 a

R. Types of Organizations

2M90#39 d
2N89# 58 c
2N88# 38 a
2M88#39 d

S. Requirements for Exemption

2N91# 53 b
2M90#40 d
2N89# 59 b
2M88#40 d

T. Unrelated Business Income

2M91#41 d
2M90#38 b
2N89# 60 c
2N88# 40 a
2M88#38 a

OTHER OBJECTIVE ANSWER FORMATS — SELECTED QUESTIONS

I. Presentation of Financial Statements or Worksheets

C. Statement of Cash Flows

1M92
Number 4 (Estimated time — — 45 to 55 minutes)

Number 4 consists of two unrelated parts.*

Instructions — Number 4(a)

Question Number 4(a) consists of 5 items. Use a No. 2 pencil to indicate your answers on the Objective Answer Sheet. These items require numerical answers and selection of the proper cash flow category. For the numerical answers, you are to both write your numerical answer in the boxes and blacken the corresponding oval below each box. **These items cannot be graded if you fail to blacken the ovals.** Write zeros in any blank boxes preceding your numerical answer. If there is a discrepancy between the amount written in the boxes and the amount indicated by the blackened ovals, the amount indicated by the blackened ovals will prevail. **Answer all items.** Your grade will be based on the total number of correct answers.

Following are selected balance sheet accounts of Zach Corp. at December 31, 1991 and 1990, and the increases or decreases in each account from 1990 to 1991. Also presented is selected income statement information for the year ended December 31, 1991, and additional information.

Selected balance sheet accounts	*1991*	*1990*	*Increase (Decrease)*
Assets:			
Accounts receivable	$ 34,000	$ 24,000	$10,000
Property, plant, and equipment	277,000	247,000	30,000
Accumulated depreciation	(178,000)	(167,000)	(11,000)
Liabilities and stockholders' equity:			
Bonds payable	49,000	46,000	3,000
Dividends payable	8,000	5,000	3,000
Common stock, $1 par	22,000	19,000	3,000
Additional paid-in capital	9,000	3,000	6,000
Retained earnings	104,000	91,000	13,000

Selected income statement information for the year ended December 31, 1991	
Sales revenue	$155,000
Depreciation	33,000
Gain on sale of equipment	13,000
Net income	28,000

*The item omitted can be found in another Content Specification Group.

1M92
Number 4(a) (continued)

Additional information

- Accounts receivable relate to sales of merchandise.
- During 1991, equipment costing $40,000 was sold for cash.
- During 1991, $20,000 of bonds payable were issued in exchange for property, plant, and equipment. There was no amortization of bond discount or premium.

Required:

Items 61 through 65 represent activities that will be reported in Zach's statement of cash flows for the year ended December 31, 1991. The following two responses are required for each item:

- Determine the amount that should be reported in Zach's 1991 statement of cash flows. To record your answer, write the number in the boxes on the Objective Answer Sheet and blacken the corresponding oval below each box. These items cannot be graded if you fail to blacken the ovals.
- Using the list below, determine the category in which the amount should be reported in the statement of cash flows and blacken the corresponding oval on the Objective Answer Sheet.

O. Operating activity
I. Investing activity
F. Financing activity

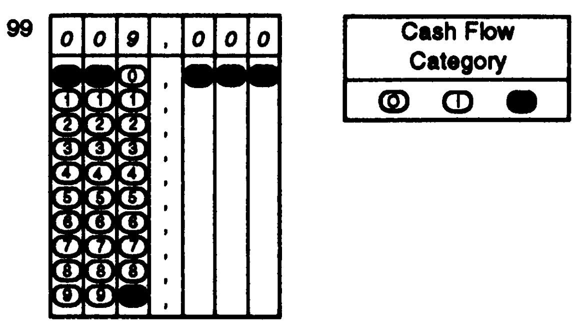
Example:

The following is an example of the manner in which the Objective Answer Sheet should be marked. **Zeros have already been marked on the Objective Answer Sheet for the ones, tens, and hundreds columns.**

Item

99. Proceeds from sale of common stock.

Answer Sheet



Items to be Answered:

61. Cash collections from customers (direct method).
62. Payments for purchase of property, plant, and equipment.
63. Proceeds from sale of equipment.
64. Cash dividends paid.
65. Redemption of bonds payable.

IX. Federal Taxation—Individuals, Estates, and Trusts

2M92
Number 4 (Estimated time — — 45 to 55 minutes)

Instructions

Question Number 4 consists of 20 items. Select the **best** answer for each item. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Answer all items.** Your grade will be based on the total number of correct answers.

Cole, a newly licensed CPA, opened an office in 1991 as a sole practitioner engaged in the practice of public accountancy. Cole reports on the cash basis for income tax purposes. Listed on page AP-155 are Cole's 1991 business and nonbusiness transactions, as well as possible tax treatments.

Required:
For each of Cole's transactions (Items 61 through 80), select the appropriate tax treatment and blacken the corresponding oval on the Objective Answer Sheet. A tax treatment may be selected once, more than once, or not at all.

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

Item

Transactions	Tax Treatments
99. Dues paid to a local health club.	P. Not deductible.

Answer Sheet

Item	Tax Treatments (select one)
99	Ⓐ Ⓑ Ⓒ Ⓓ Ⓔ Ⓕ Ⓖ Ⓗ Ⓘ Ⓙ Ⓚ Ⓛ Ⓜ Ⓝ Ⓞ ●

2M92
Number 4 (continued)

Items to be Answered:

Transactions

61. Fees received for jury duty.
62. Interest income on mortgage loan receivable.
63. Penalty paid to bank on early withdrawal of savings.
64. Writeoffs of uncollectible accounts receivable from accounting practice.
65. Cost of attending review course in preparation for the Uniform CPA Examination.
66. Fee for the biennial permit to practice as a CPA.
67. Costs of attending CPE courses in fulfillment of state board requirements.
68. Contribution to a qualified Keogh retirement plan.
69. Loss sustained from nonbusiness bad debt.
70. Loss sustained on sale of "Small Business Corporation" (Section 1244) stock.
71. Taxes paid on land owned by Cole and rented out as a parking lot.
72. Interest paid on installment purchases of household furniture.
73. Alimony paid to former spouse who reports the alimony as taxable income.
74. Personal medical expenses charged on credit card in December 1991 but not paid until January 1992.
75. Personal casualty loss sustained.
76. State inheritance tax paid on bequest received.
77. Foreign income tax withheld at source on dividend received.
78. Computation of self-employment tax.
79. One-half of self-employment tax paid with 1991 return filed in April 1992.
80. Insurance premiums paid on Cole's life.

Tax Treatments

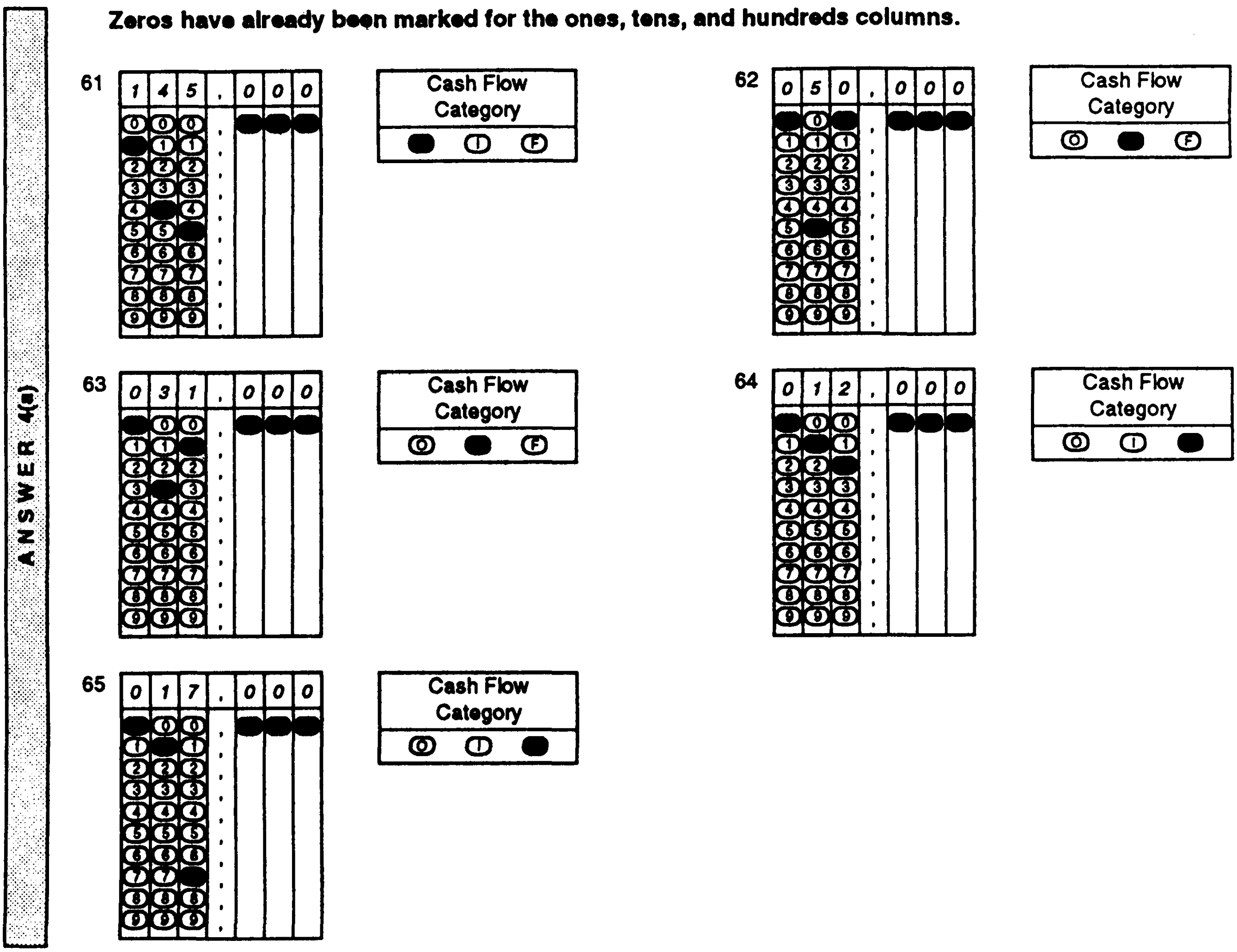
A. Taxable as interest income in Schedule B — Interest and Dividend Income.
B. Taxable as other income on page 1 of Form 1040.
C. Not taxable.
D. Deductible on page 1 of Form 1040 to arrive at adjusted gross income.
E. Deductible in Schedule A — Itemized Deductions, subject to threshold of 7.5% of adjusted gross income.
F. Deductible in Schedule A — Itemized Deductions, subject to threshold of 10% of adjusted gross income and additional threshold of $100.
G. Deductible in full in Schedule A — Itemized Deductions (cannot be claimed as a credit).
H. Deductible in Schedule B — Interest and Dividend Income.
I. Deductible in Schedule C — Profit or Loss from Business.
J. Deductible in Schedule D — Capital Gains or Losses.
K. Deductible in Schedule E — Supplemental Income and Loss.
L. Deductible in Form 4797 — Sales of Business Property.
M. Claimed in Form 1116 — Foreign Tax Credit, or in Schedule A — Itemized Deductions, at taxpayer's option.
N. Based on gross self-employment income.
O. Based on net earnings from self-employment.
P. Not deductible.

SELECTED OTHER OBJECTIVE ANSWER FORMATS — UNOFFICIAL ANSWERS

I. Presentation of Financial Statements or Worksheets

C. Statement of Cash Flows

1M92
Answer 4(a) (30 points)



IX. Federal Taxation—Individuals, Estates, and Trusts

2M92

Answer 4 (30 points)

ANSWER 4

Item	Tax Treatments (select one)	Item	Tax Treatments (select one)
61	A ● C D E F G H I J K L M N O P	71	A B C D E F G H I J ● L M N O P
62	● B C D E F G H I J K L M N O P	72	A B C D E F G H I J K L M N O ●
63	A B C ● E F G H I J K L M N O P	73	A B C ● E F G H I J K L M N O P
64	A B C D E F G H I J K L M N O ●	74	A B C D ● F G H I J K L M N O P
65	A B C D E F G H I J K L M N O ●	75	A B C D E ● G H I J K L M N O P
66	A B C D E F G H ● J K L M N O P	76	A B C D E F G H I J K L M N O ●
67	A B C D E F G H ● J K L M N O P	77	A B C D E F G H I J K L ● N O P
68	A B C ● E F G H I J K L M N O P	78	A B C D E F G H I J K L M N ● P
69	A B C D E F G H I ● K L M N O P	79	A B C ● E F G H I J K L M N O P
70	A B C D E F G H I J K ● M N O P	80	A B C D E F G H I J K L M N O ●

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1M91
Number 4 (Estimated time —— 45 to 55 minutes)

Kern, Inc. had the following long-term receivable account balances at December 31, 1989:

Note receivable from the sale of an idle building	$750,000
Note receivable from an officer	200,000

Transactions during 1990 and other information relating to Kern's long-term receivables follow:

- The $750,000 note receivable is dated May 1, 1989, bears interest at 9%, and represents the balance of the consideration Kern received from the sale of its idle building to Able Co. Principal payments of $250,000 plus interest are due annually beginning May 1, 1990. Able made its first principal and interest payment on May 1, 1990. Collection of the remaining note installments is reasonably assured.

- The $200,000 note receivable is dated December 31, 1987, bears interest at 8%, and is due on December 31, 1992. The note is due from Frank Black, president of Kern, Inc., and is collateralized by 5,000 shares of Kern's common stock. Interest is payable annually on December 31, and all interest payments were made through December 31, 1990. The quoted market price of Kern's common stock was $45 per share on December 31, 1990.

- On April 1, 1990, Kern sold a patent to Frey Corp. in exchange for a $100,000 noninterest bearing note due on April 1, 1992. There was no established exchange price for the patent, and the note had no ready market. The prevailing interest rate for this type of note was 10% at April 1, 1990. The present value of $1 for two periods at 10% is 0.826. The patent had a carrying amount of $40,000 at January 1, 1990, and the amortization for the year ended December 31, 1990, would have been $8,000. Kern is reasonably assured of collecting the note receivable from Frey.

- On July 1, 1990, Kern sold a parcel of land to Barr Co. for $400,000 under an installment sale contract. Barr made a $120,000 cash down payment on July 1, 1990, and signed a four-year 10% note for the $280,000 balance. The equal annual payments of principal and interest on the note will be $88,332, payable on July 1 of each year from 1991 through 1994. The fair value of the land at the date of sale was $400,000. The cost of the land to Kern was $300,000. Collection of the remaining note installments is reasonably assured.

Required:
Prepare the following and show supporting computations:

a. Long-term receivables section of Kern's December 31, 1990, balance sheet.

b. Schedule showing current portion of long-term receivables and accrued interest receivable to be reported in Kern's December 31, 1990, balance sheet.

c. Schedule showing interest revenue from long-term receivables and gains recognized on sale of assets to be reported in Kern's 1990 income statement.

1M91

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

Cord Corp., a nonpublic enterprise, requires audited financial statements for credit purposes. After making normal adjusting entries, but before closing the accounting records for the year ended December 31, 1990, Cord's controller prepared the following financial statements for 1990:

Cord Corp.
STATEMENT OF FINANCIAL POSITION
December 31, 1990

Assets	
Cash	$1,225,000
Marketable equity securities, at cost	125,000
Accounts receivable	460,000
Allowance for doubtful accounts	(55,000)
Inventories	530,000
Property and equipment	620,000
Accumulated depreciation	(280,000)
Total assets	$2,625,000
Liabilities and Stockholders' Equity	
Accounts payable and accrued liabilities	$1,685,000
Income tax payable	110,000
Common stock, $20 par	300,000
Additional paid-in capital	75,000
Retained earnings	455,000
Total liabilities and stockholders' equity	$2,625,000

Cord Corp.
STATEMENT OF INCOME
For the Year Ended December 31, 1990

Net sales	$1,700,000
Operating expenses:	
Cost of sales	570,000
Selling and administrative	448,000
Depreciation	42,000
Total operating expenses	1,060,000
Income before income tax	640,000
Income tax expense	192,000
Net income	$ 448,000

Cord's tax rate for all income items was 30% for both 1990 and 1989, and it made estimated tax payments when due. After 1991, the enacted tax rate is 25%. During the course of the audit, the following additional information (not considered when the above statements were prepared) was obtained:

1. The investment portfolio consists of short-term investments for which total market value exceeded cost at December 31, 1989. On February 2, 1990, Cord sold one investment costing $100,000 for $130,000. The total of the sale proceeds was credited to the investment account.

2. At December 31, 1990, the market value of the remaining securities in the portfolio was $142,000.

3. The $530,000 inventory total, which was based on a physical count at December 31, 1990, was priced at cost. Subsequently, it was determined that the inventory cost was overstated by $66,000. At December 31, 1990, the inventory's market value approximated the adjusted cost.

4. Pollution control devices costing $48,000, which is high in relation to the cost of the original equipment, were installed on December 29, 1989, and were charged to repairs in 1989.

5. The original equipment referred to in Item 4, which had a remaining useful life of six years on December 29, 1989, is being depreciated by the straight-line method for both financial and tax reporting.

6. A lawsuit was filed against Cord in October 1990 claiming damages of $250,000. Cord's legal counsel believes that an unfavorable outcome is probable, and a reasonable estimate of the court's award to the plaintiff is $60,000, which will be paid in 1992 if the case is settled.

7. Cord determined that its accumulated benefits obligation under the pension plan exceeded the fair value of plan assets by $40,000 at December 31, 1990. Cord has unrecognized prior service cost of $50,000 at December 31, 1990. Cord funds the total pension expense each year.

Required:

Prepare journal entries, without explanations, to record the effects of the foregoing data on Cord's accounting records at December 31, 1990. Do **not** prepare corrected financial statements for 1990. The journal entries should be numbered to correspond with the numbers in the additional information. Include as the last entry any necessary adjustments to the 1990 income tax expense, and support your computations for this entry.

1N90
Number 4 (Estimated time —— 45 to 55 minutes)

Presented below is the unaudited balance sheet as of December 31, 1989, prepared by the bookkeeper of Zues Manufacturing Corp.

Zues Manufacturing Corp.
BALANCE SHEET
For the Year Ended December 31, 1989

Assets	
Cash	$ 225,000
Accounts receivable (net)	345,700
Inventories	560,000
Prepaid income taxes	40,000
Investments	57,700
Land	450,000
Building	1,750,000
Machinery and equipment	1,964,000
Goodwill	37,000
Total assets	$5,429,400

Liabilities & Stockholders' Equity	
Accounts payable	$ 133,800
Mortgage payable	900,000
Notes payable	500,000
Lawsuit liability	80,000
Income taxes payable	61,200
Deferred tax liability	28,000
Accumulated depreciation	420,000
Total liabilities	$2,123,000
Common stock, $50 par; 40,000 shares issued	2,231,000
Retained earnings	1,075,400
Total stockholders' equity	$3,306,400
Total liabilities and stockholders' equity	$5,429,400

1N90
Number 4 (cont.)

Your firm has been engaged to perform an audit, during which the following data are found:

- Checks totaling $14,000 in payment of accounts payable were mailed on December 30, 1989 but were not recorded until 1990. Late in December 1989, the bank returned a customer's $2,000 check, marked "NSF," but no entry was made. Cash includes $100,000 restricted for building purposes.

- Included in accounts receivable is a $30,000 note due on December 31, 1992 from Zues' president.

- During 1989, Zues purchased 500 shares of common stock of a major corporation that supplies Zues with raw materials. Total cost of this stock was $51,300, and market value on December 31, 1989 was $47,000. The decline in market value is considered temporary. Zues plans to hold these shares indefinitely.

- Treasury stock was recorded at cost when Zues purchased 200 of its own shares for $32 per share in May 1989. This amount is included in investments.

- On December 30, 1989, Zues borrowed $500,000 from a bank in exchange for a 10% note payable, maturing December 30, 1994. Equal principal payments are due December 30 of each year, beginning in 1990. This note is collateralized by a $250,000 tract of land acquired as a potential future building site, which is included in land.

- The mortgage payable requires $50,000 principal payments, plus interest, at the end of each month. Payments were made on January 31 and February 28, 1990. The balance of this mortgage was due June 30, 1990. On March 1, 1990, prior to issuance of the audited financial statements, Zues consummated a noncancelable agreement with the lender to refinance this mortgage. The new terms require $100,000 annual principal payments, plus interest, on February 28 of each year, beginning in 1991. The final payment is due February 28, 1998.

- The lawsuit liability will be paid in 1990.

- Zues elected early application of FASB Statement No. 96, *Accounting for Income Taxes.*

  The following is an analysis of the deferred tax liability at December 31, 1989:

Deferred taxes related to depreciation	$48,000
Deferred taxes related to a lawsuit liability	(20,000)
Net deferred tax liability	$28,000

  $25,000 of the deferred taxes related to depreciation will reverse in 1990.

- The current income tax expense reported in Zues' 1989 income statement was $61,200.

- The company was authorized to issue 100,000 shares of $50 par value common stock.

Required:

Prepare a corrected classified balance sheet as of December 31, 1989. This financial statement should include a proper heading, format and necessary descriptions.

B. Income Statement

In February 1992, the FASB issued *Statement of Financial Accounting Standards No. 109,* "Accounting for Income Taxes," superceding *Statement of Financial Accounting Standards No. 96,* "Accounting for Income Taxes." Accordingly, future examinations will test SFAS No. 109.

1M89
Number 4 (Estimated time —— 45 to 55 minutes)

Before closing the books for the year ended December 31, 1988, Pitt Corp. prepared the following condensed trial balance:

Condensed Trial Balance
December 31, 1988

	Debit	Credit
Total assets	$ 7,082,500	
Total liabilities		$ 1,700,000
Common stock		1,250,000
Additional paid-in capital		2,097,500
Donated capital		90,000
Retained earnings, 1/1/88		1,650,000
Net sales		6,250,000
Cost of sales	3,750,000	
Selling and administrative expenses	1,212,500	
Interest expense	122,500	
Gain on sale of long-term investments		130,000
Income tax expense	300,000	
Loss on disposition of plant assets	225,000	
Loss due to earthquake damage	475,000	
	$13,167,500	$13,167,500

Other financial data for the year ended December 31, 1988:

Federal income tax

Estimated tax payments	$200,000
Accrued	100,000
Total charged to income tax expense (Does not properly reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes.)	$300,000

Pitt elected to apply the provisions of FASB Statement No. 96, *Accounting for Income Taxes,* in its financial statements for the year ended December 31, 1988. The enacted tax rate on all types of taxable income for the current and future years is 30%. The alternative minimum tax is less than the regular income tax.

Temporary difference

Excess of book basis over tax basis in depreciable assets (arising from equipment donated as a capital contribution on December 31, 1988 and expected to be depreciated over five years beginning in 1989). There were no temporary differences prior to 1988. $90,000

Non-deductible expenditure

Officers' life insurance expense $70,000

Earthquake damage

This damage is considered unusual and infrequent.

Capital structure

Common stock, par value $5 per share, traded on a national exchange:

Number of shares:	
Outstanding at 1/1/88	200,000
Issued on 3/30/88 as a 10% stock dividend	20,000
Sold for $25 per share on 6/30/88	30,000
Outstanding at 12/31/88	250,000

1M89
Number 4 (cont.)

Required:

a. Using the multiple-step format, prepare a formal income statement for Pitt for the year ended December 31, 1988.

b. Prepare a schedule to reconcile net income to taxable income reportable on Pitt's tax return for 1988.

2M88
Number 4 (Estimated time —— 45 to 55 minutes)

The following information pertains to Arlon Corporation:

TRIAL BALANCE
December 31, 1987

	Debit	*Credit*
Cash	$ 25,000	
Accounts receivable, net	75,000	
Inventory	125,000	
Property, plant, and equipment	755,000	
Accumulated depreciation		$239,000
Accounts payable		70,000
Income tax payable		6,000
Rental revenue received in advance		5,000
Notes payable		55,000
Common stock, $.05 par		50,000
Additional paid-in capital		305,000
Retained earnings, 1/1/87		150,000
Sales — regular		500,000
Sales — Mem Division		100,000
Proceeds from term life insurance policy		10,000
Cost of sales — regular	310,000	
Cost of sales — Mem Division	45,000	
Administrative expenses — regular	103,000	
Administrative expenses — Mem Division	15,000	
Interest expense — regular	10,500	
Interest expense — Mem Division	7,000	
Loss on disposal of Mem Division	12,500	
Gain on acquisition of bonds payable		13,000
Income tax expense	20,000	
Totals	$1,503,000	$1,503,000

Other Information

Income tax

Paid with Federal Tax Deposit Forms	$14,000
Accrued	6,000
Total charged to income tax expense	$20,000*

*Does not reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes.

Income per income tax return	$99,000
Tax rate on all types of taxable income	22%

Timing differences

Depreciation per financial statements — regular	$30,000	
Depreciation per income tax return	46,000	$16,000
Rental revenue received in advance		5,000

Permanent difference

Proceeds from term life insurance policy	10,000

Discontinued operations

On June 30, 1987, Arlon sold its Mem Division for $200,000. The carrying amount of this business segment was $212,500 at that date. This sale was considered as a disposal of a segment of a business for financial statement purposes. Since there was no phaseout period, the measurement date was June 30, 1987.

Liabilities

On June 30, 1987, Arlon acquired $100,000 carrying amount of its long-term bonds for $87,000. All other liabilities mature in 1988.

Capital structure

Common stock, $.05 par, traded over-the-counter; 1,000,000 shares issued and outstanding at 1/1/87 and 12/31/87.

Required:

Using the multiple-step format, prepare a formal income statement for Arlon for the year ended December 31, 1987, together with supporting computations of current and deferred income taxes and of income from discontinued operations.

C. Statement of Cash Flows

1N90
Number 5 (Estimated time —— 40 to 50 minutes)

Presented below are the condensed statements of financial position of Linden Consulting Associates as of December 31, 1989 and 1988, and the condensed statement of income for the year ended December 31, 1989.

Linden Consulting Associates
CONDENSED STATEMENTS OF FINANCIAL POSITION
December 31, 1989 and 1988

	1989	*1988*	*Net change increase (decrease)*
Assets			
Cash	$ 652,000	$ 280,000	$372,000
Accounts receivable, net	446,000	368,000	78,000
Investment in Zach, Inc., at equity	550,000	466,000	84,000
Property and equipment	1,270,000	1,100,000	170,000
Accumulated depreciation	(190,000)	(130,000)	(60,000)
Excess of cost over book value of investment in Zach, Inc. (net)	152,000	156,000	(4,000)
Total assets	$2,880,000	$2,240,000	$640,000
Liabilities and Partners' Equity			
Accounts payable and accrued expenses	$ 320,000	$ 270,000	$ 50,000
Mortgage payable	250,000	270,000	(20,000)
Partners' equity	2,310,000	1,700,000	610,000
Total liabilities and partners' equity	$2,880,000	$2,240,000	$640,000

Linden Consulting Associates
CONDENSED STATEMENT OF INCOME
For the Year Ended December 31, 1989

Fee revenue	$2,664,000
Operating expenses	1,940,000
Operating income	724,000
Equity in earnings of Zach, Inc. (net of $4,000 amortization of excess of cost over book value)	176,000
Net income	$ 900,000

1N90
Number 5 (cont.)

Additional information:

- On December 31, 1988, partners' capital and profit sharing percentages were as follows:

	Capital	*Profit sharing %*
Garr	$1,020,000	60%
Pat	680,000	40%
	$1,700,000	

- On January 1, 1989, Garr and Pat admitted Scott to the partnership for a cash payment of $340,000 to Linden Consulting Associates as the agreed amount of Scott's beginning capital account. In addition, Scott paid a $50,000 cash bonus directly to Garr and Pat. This amount was divided $30,000 to Garr and $20,000 to Pat. The new profit sharing arrangement is as follows:

Garr	50%
Pat	30%
Scott	20%

- On October 1, 1989, Linden purchased and paid for an office computer costing $170,000, including $15,000 for sales tax, delivery, and installation. There were no dispositions of property and equipment during 1989.

- Throughout 1989, Linden owned 25% of Zach, Inc.'s common stock. As a result of this ownership interest, Linden can exercise significant influence over Zach's operating and financial policies. During 1989, Zach paid dividends totaling $384,000 and reported net income of $720,000. Linden's 1989 amortization of excess of cost over book value in Zach was $4,000.

- Partners' drawings for 1989 were as follows:

Garr	$280,000
Pat	200,000
Scott	150,000
	$630,000

Required:

a. Using the direct method, prepare Linden's statement of cash flows for the year ended December 31, 1989.

b. Prepare a reconciliation of net income to net cash provided by operating activities.

c. Prepare an analysis of changes in partners' capital accounts for the year ended December 31, 1989.

1N89

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

Presented below are the balance sheet accounts of Kern, Inc. as of December 31, 1988 and 1987 and their net changes.

	1988	*1987*	*Net change*
Assets			
Cash	$ 471,000	$ 307,000	$ 164,000
Marketable equity securities, at cost	150,000	250,000	(100,000)
Allowance to reduce marketable equity securities to market	(10,000)	(25,000)	15,000
Accounts receivable, net	550,000	515,000	35,000
Inventories	810,000	890,000	(80,000)
Investment in Word Corp., at equity	420,000	390,000	30,000
Property, plant and equipment	1,145,000	1,070,000	75,000
Accumulated depreciation	(345,000)	(280,000)	(65,000)
Patent, net	109,000	118,000	(9,000)
Total assets	$3,300,000	$3,235,000	$ 65,000
Liabilities and Stockholders' Equity			
Accounts payable and accrued liabilities	$ 845,000	$ 960,000	$ (115,000)
Note payable, long-term	600,000	900,000	(300,000)
Deferred income taxes	190,000	190,000	—
Common stock, $10 par value	850,000	650,000	200,000
Additional paid-in capital	230,000	170,000	60,000
Retained earnings	585,000	365,000	220,000
Total liabilities and stockholders' equity	$3,300,000	$3,235,000	$ 65,000

Additional information:

- On January 2, 1988, Kern sold equipment costing $45,000, with a carrying amount of $28,000, for $18,000 cash.
- On March 31, 1988, Kern sold one of its marketable equity security holdings for $119,000 cash. There were no other transactions involving marketable equity securities.
- On April 15, 1988, Kern issued 20,000 shares of its common stock for cash at $13 per share.
- On July 1, 1988, Kern purchased equipment for $120,000 cash.
- Kern's net income for 1988 is $305,000. Kern paid a cash dividend of $85,000 on October 26, 1988.
- Kern acquired a 20% interest in Word Corp.'s common stock during 1985. There was no goodwill attributable to the investment which is appropriately accounted for by the equity method. Word reported net income of $150,000 for the year ended December 31, 1988. No dividend was paid on Word's common stock during 1988.

Required:

Prepare a statement of cash flows for Kern, Inc. for the year ended December 31, 1988 using the indirect method. A worksheet is **not** required.

D. Statement of Owners' Equity

1N91

Number 4 (Estimated time —— 45 to 55 minutes)

The following information pertains to Dey Toys, a calendar-year sole proprietorship, which maintained its books on the cash basis during the year.

Dey Toys
Trial Balance
December 31, 1990

	Dr.	*Cr.*
Cash	8,200	
Accounts receivable, 12/31/89	9,000	
Inventory, 12/31/89	40,000	
Machinery & equipment	70,000	
Leasehold improvements	28,800	
Accumulated depreciation, 12/31/89		18,000
Accounts payable, 12/31/89		9,600
Payroll taxes withheld		1,700
Dey, drawings	—	
Dey, capital, 12/31/89		67,300
Sales		374,000
Purchases	165,400	
Salaries	107,000	
Payroll taxes	5,800	
Insurance	4,800	
Dey's living expenses	7,800	
Rent	16,800	
Utilities	7,000	
	470,600	470,600

During 1990, Dey signed a new 8-year lease for its retail store and is in the process of negotiating a loan to remodel the premises. The bank requires Dey to present 1990 financial statements on the accrual basis of accounting. During the course of a review engagement, Dey's accountant obtained the following additional information:

1. Amounts due from customers totaled $17,800 at December 31, 1990.

2. An analysis of the above receivables revealed that an allowance for uncollectible accounts of $2,100 should be provided.

3. The inventory totaled $46,000 based on a physical count of the goods at December 31, 1990. The inventory was priced at cost, which approximates market value.

4. On April 1, 1990, Dey paid $4,800 to renew its comprehensive insurance coverage for one year. The premium was $4,320 on the previous policy that expired on March 31, 1990.

5. On signing the new lease for the retail store on October 1, 1990, Dey paid $16,800 for one year's advance rent for the lease year ending September 30, 1991. The $15,000 annual rent under the previous lease was paid on October 1, 1989, for the lease year ended September 30, 1990.

6. In anticipation of signing a new lease, Dey constructed storage space that cost $28,800. The improvements were completed on October 1, 1990, and have an estimated useful life of 10 years. No provision for depreciation or amortization has been recorded. Depreciation on machinery and equipment was $10,600 for 1990.

7. Unpaid invoices for toy purchases totaled $18,600 at December 31, 1990.

8. Accrued expenses at December 31, 1989 and 1990, were as follows:

	1989	*1990*
Utilities	$ 500	$ 850
Salaries	500	770
Payroll taxes	600	900
	$1,600	$2,520

9. Dey is being sued for $175,000. The coverage under the comprehensive insurance policy is limited to $100,000, Dey's attorney believes that an unfavorable outcome is probable and a reasonable estimate of the settlement is $135,000.

10. The salaries account includes $4,000 per month paid to the proprietor. Dey also receives $150 per week for living expenses.

Required: Detach and complete the tear-out worksheet on page AP-169. Turn in the worksheet in the proper sequence with other answer sheets.

a. Complete the tear-out worksheet to convert the trial balance of Dey Toys to the accrual basis of accounting for the year ended December 31, 1990. Formal journal entries are not required to support your adjustments. However, use the numbers given with the additional information to cross reference the postings in the adjustment columns on the worksheet.

b. Prepare a statement of changes in Dey's capital for the year ended December 31, 1990.

1N91
Number 4 (Tear-out Worksheet)

Candidate's No. ______
State ______
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Dey Toys
WORKSHEET TO CONVERT
TRIAL BALANCE TO ACCRUAL BASIS
December 31, 1990

Account Title	Cash Basis Dr.	Cash Basis Cr.	Adjustments Dr.	Adjustments Cr.	Accrual Basis Dr.	Accrual Basis Cr.
Cash	8,200					
Accounts receivable	9,000					
Inventory	40,000					
Machinery & equipment	70,000					
Leasehold improvements	28,800					
Accumulated depreciation & amort.		18,000				
Accounts payable		9,600				
Payroll taxes withheld		1,700				
Dey, drawings						
Dey, capital		67,300				
Sales		374,000				
Purchases	165,400					
Salaries	107,000					
Payroll taxes	5,800					
Insurance	4,800					
Dey's living expenses	7,800					
Rent	16,800					
Utilities	7,000					
	470,600	470,600				

DETACH, COMPLETE, AND TURN IN THIS TEAR-OUT WORKSHEET IN THE PROPER SEQUENCE WITH OTHER ANSWER SHEETS.

1M90
Number 5 (Estimated time — — 40 to 50 minutes)

Mart, Inc., is a public company whose shares are traded in the over-the-counter market. At December 31, 1988, Mart had 6,000,000 authorized shares of $5 par value common stock, of which 2,000,000 shares were issued and outstanding. The stockholders' equity accounts at December 31, 1988 had the following balances:

Common stock	$10,000,000
Additional paid-in capital	7,500,000
Retained earnings	3,250,000

Transactions during 1989 and other information relating to the stockholders' equity accounts were as follows:

- On January 5, 1989, Mart issued at $54 per share, 100,000 shares of $50 par value, 9% cumulative, convertible preferred stock. Each share of preferred stock is convertible, at the option of the holder, into two shares of common stock. Mart had 250,000 authorized shares of preferred stock. The preferred stock has a liquidation value of $55 per share.

- On February 1, 1989, Mart reacquired 20,000 shares of its common stock for $16 per share. Mart uses the cost method to account for treasury stock.

- On March 15, 1989, Mart paid $200,000 for 10,000 shares of common stock of Lew, Inc., a public company whose stock is traded on a national stock exchange. This stock was acquired for long-term investment purposes and had a fair market value of $15 per share on December 31, 1989. This decline in market value was not considered permanent.

- On April 30, 1989, Mart had completed an additional public offering of 500,000 shares of its $5 par value common stock. The stock was sold to the public at $12 per share, net of offering costs.

- On June 17, 1989, Mart declared a cash dividend of $1 per share of common stock, payable on July 10, 1989 to stockholders of record on July 1, 1989.

- On November 6, 1989, Mart sold 10,000 shares of treasury stock for $21 per share.

- On December 7, 1989, Mart declared the yearly cash dividend on preferred stock, payable on January 7, 1990 to stockholders of record on December 31, 1989.

- On January 17, 1990, before the books were closed for 1989, Mart became aware that the ending inventories at December 31, 1988 were overstated by $200,000. The after-tax effect on 1988 net income was $140,000. The appropriate correction entry was recorded the same day.

- After correction of the beginning inventories, net income for 1989 was $2,250,000.

Required:

a. Prepare a statement of retained earnings for the year ended December 31, 1989. Assume that only single period financial statements for 1989 are presented.

b. Prepare the stockholders' equity section of Mart's balance sheet at December 31, 1989.

c. Compute the book value per share of common stock at December 31, 1989.

E. Consolidated Financial Statements or Worksheets

1N91
Number 5 (Estimated time — — 40 to 50 minutes)

Pine Corp. issued 200,000 shares of its $10 par common stock on March 31, 1990, to acquire all of the outstanding $25 par value common stock of Strand, Inc. The business combination meets all conditions for a pooling of interests. On March 31, 1990, the market price of Pine's common stock was $35 a share. Both corporations continued to operate as separate businesses, maintaining separate accounting records with years ending December 31.

On March 31, 1990, immediately before the combination, the stockholders' equities were

	Pine	*Strand*
Common stock	$ 5,500,000	$2,500,000
Additional paid-in capital	4,200,000	470,000
Retained earnings	7,360,000	2,430,000
	$17,060,000	$5,400,000

Additional information

- During March 1990, Pine paid $720,000 for expenditures relating to the business combination with Strand.

- Pine accounts for its investment in Strand using the equity method.

- On March 31, 1990, the fair values of Strand's assets and liabilities equaled their book values, except for its long-term investment in marketable equity securities, for which the aggregate market value exceeded aggregate cost by $600,000.

- On March 10, 1990, Strand paid a cash dividend totaling $250,000 on its common stock.

- On November 15, 1990, Pine paid a cash dividend totaling $1,500,000 on its common stock.

- During August 1990, Pine sold merchandise to Strand at a profit of $800,000. At December 31, 1990, one-fourth of this merchandise remained in Strand's inventory.

- For the period April 1 through December 31, 1990, Strand paid Pine management fees totaling $150,000.

- Strand's 1990 net income was $1,450,000. Pine's 1990 income was $2,240,000, before considering equity in Strand's net income.

- The balances in retained earnings at December 31, 1989, were $6,820,000 and $2,290,000 for Pine and Strand, respectively.

Required:

a. Prepare Pine Corp.'s journal entries to record the business combination with Strand, Inc. and the expenditures relating to the business combination.

b. Prepare a schedule to compute the investment in Strand, Inc., at equity, at December 31, 1990.

c. Prepare a formal consolidated statement of changes in retained earnings of Pine Corp. and its subsidiary Strand, Inc. for the year ended December 31, 1990.

1M90

Number 4 (Estimated time —— 45 to 55 minutes)

Cain Corp. acquired all of the outstanding $10 par value voting common stock of Frey, Inc. on January 1, 1989 in exchange for 25,000 shares of its $10 par value voting common stock. On December 31, 1988, Cain's common stock had a closing market price of $30 per share on a national stock exchange. The acquisition was appropriately accounted for as a purchase. Both companies continued to operate as separate business entities maintaining separate accounting records with years ending December 31.

On December 31, 1989, the companies had condensed financial statements as follows:

	Cain Corp. Dr. (Cr.)	*Frey, Inc. Dr. (Cr.)*
Income Statement		
Net sales	$(3,800,000)	$(1,500,000)
Dividends from Frey	(40,000)	
Gain on sale of warehouse	(30,000)	
Cost of goods sold	2,360,000	870,000
Operating expenses (including depreciation)	1,100,000	440,000
Net income	$ (410,000)	$ (190,000)
Retained Earnings Statement		
Balance, 1/1/89	$ (440,000)	$ (156,000)
Net income	(410,000)	(190,000)
Dividends paid		40,000
Balance, 12/31/89	$ (850,000)	$ (306,000)
Balance Sheet		
Assets:		
Cash	$ 570,000	$ 150,000
Accounts receivable (net)	860,000	350,000
Inventories	1,060,000	410,000
Land, plant and equipment	1,320,000	680,000
Accumulated depreciation	(370,000)	(210,000)
Investment in Frey (at cost)	750,000	
Total Assets	$ 4,190,000	$ 1,380,000
Liabilities & Stockholders' Equity:		
Accounts payable & accrued expenses	$(1,340,000)	$ (594,000)
Common stock ($10 par)	(1,700,000)	(400,000)
Additional paid-in capital	(300,000)	(80,000)
Retained earnings	(850,000)	(306,000)
Total Liabilities & Stockholders' Equity	$(4,190,000)	$(1,380,000)

1M90
Number 4 (cont.)

Additional information follows:

- There were no changes in the common stock and additional paid-in capital accounts during 1989 except the one necessitated by Cain's acquisition of Frey.

- At the acquisition date, the fair value of Frey's machinery exceeded its book value by $54,000. The excess cost will be amortized over the estimated average remaining life of six years. The fair values of all of Frey's other assets and liabilities were equal to their book values. Any goodwill resulting from the acquisition will be amortized over a 20-year period.

- On July 1, 1989, Cain sold a warehouse facility to Frey for $129,000 cash. At the date of sale, Cain's book values were $33,000 for the land and $66,000 for the undepreciated cost of the building. Based on a real estate appraisal, Frey allocated $43,000 of the purchase price to land and $86,000 to building. Frey is depreciating the building over its estimated five-year remaining useful life by the straight-line method with no salvage value.

- During 1989, Cain purchased merchandise from Frey at an aggregate invoice price of $180,000, which included a 100% markup on Frey's cost. At December 31, 1989, Cain owed Frey $86,000 on these purchases, and $36,000 of this merchandise remained in Cain's inventory.

Required: Detach the tear-out worksheet on page AP-173.

Complete the tear-out worksheet that would be used to prepare a consolidated income statement and a consolidated retained earnings statement for the year ended December 31, 1989, and a consolidated balance sheet as of December 31, 1989. Formal consolidated statements and adjusting entries are **not** required. Ignore income tax considerations. Supporting computations should be in good form. Include the completed tear-out worksheet in the proper sequence and include it with the other answer sheets.

1M90
Number 4 (Tear-out Worksheet)

Candidate's No. ____________
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Cain Corp. and Subsidiary
CONSOLIDATING STATEMENT WORKSHEET
December 31, 1989

Income Statement	*Cain Corp. Dr. (Cr.)*	*Frey, Inc. Dr. (Cr.)*	*Adjustments & Eliminations Dr.*	*Adjustments & Eliminations Cr.*	*Adjusted Balance*
Net sales	(3,800,000)	(1,500,000)			
Dividends from Frey	(40,000)				
Gain on sale of warehouse	(30,000)				
Cost of goods sold	2,360,000	870,000			
Operating expenses (including depreciation)	1,100,000	440,000			
Net income	(410,000)	(190,000)			
Retained Earnings Statement					
Balance, 1/1/89	(440,000)	(156,000)			
Net income	(410,000)	(190,000)			
Dividends paid		40,000			
Balance, 12/31/89	(850,000)	(306,000)			
Balance Sheet					
Assets: Cash	570,000	150,000			
Accounts receivable (net)	860,000	350,000			
Inventories	1,060,000	410,000			
Land, plant and equipment	1,320,000	680,000			
Accumulated depreciation	(370,000)	(210,000)			
Investment in Frey (at cost)	750,000				
Total Assets	4,190,000	1,380,000			
Liabilities & Stockholders' Equity: Accounts payable & accrued expenses	(1,340,000)	(594,000)			
Common stock ($10 par)	(1,700,000)	(400,000)			
Additional paid-in capital	(300,000)	(80,000)			
Retained earnings	(850,000)	(306,000)			
Total Liabilities & Stockholders' Equity	(4,190,000)	(1,380,000)			

1N88
Number 5 (Estimated time —— 40 to 50 minutes)

Peel, Inc., acquired all of the outstanding $25 par value common stock of Stagg, Inc., on June 30, 1987, in exchange for 40,000 shares of its $25 par value common stock. The business combination meets all conditions for a pooling of interests. On June 30, 1987, Peel's common stock closed at $65 per share on a national stock exchange. Both corporations continued to operate as separate businesses maintaining separate accounting records with years ending December 31.

On December 31, 1987, after year-end adjustments and closing nominal accounts, the companies had condensed balance sheet accounts as follows:

	Peel	*Stagg*
Assets:		
Cash	$ 925,000	$ 300,000
Accounts and other receivables	2,140,000	835,000
Inventories	2,310,000	1,045,000
Land	600,000	330,000
Depreciable assets, net	4,525,000	1,980,000
Investment in Stagg, Inc.	2,430,000	—
Long-term investments and other assets	865,000	385,000
	$13,795,000	$4,875,000
Liabilities and Stockholders' Equity:		
Accounts payable and other current liabilities	$ 2,465,000	$1,145,000
Long-term debt	1,900,000	1,300,000
Common stock, $25 par value	3,200,000	1,000,000
Additional paid-in capital	1,850,000	190,000
Retained earnings	4,380,000	1,240,000
	$13,795,000	$4,875,000

Additional information is as follows:

- Peel uses the equity method of accounting for its investment in Stagg. The investment in Stagg has not been adjusted for any intercompany transactions.
- On June 30, 1987, Stagg's assets and liabilities had fair values equal to the book balances with the exception of land, which had a fair value of $550,000.
- On June 15, 1987, Stagg paid a cash dividend of $4 per share on its common stock.
- On December 10, 1987, Peel paid a cash dividend totaling $256,000 on its common stock.
- On June 30, 1987, immediately before the combination, the stockholders' equities were:

	Peel	*Stagg*
Common stock	$2,200,000	$1,000,000
Additional paid-in capital	1,660,000	190,000
Retained earnings	3,036,000	980,000
	$6,896,000	$2,170,000

- Stagg's long-term debt consisted of 10% ten-year bonds issued at face value on March 31, 1981. Interest is payable semiannually on March 31 and September 30. Peel had purchased Stagg's bonds at face value of $320,000 in 1981, and there was no change in ownership through December 31, 1987.
- During October 1987 Peel sold merchandise to Stagg at an aggregate invoice price of $720,000, which included a profit of $180,000. At December 31, 1987, one-half of the merchandise remained in Stagg's inventory, and Stagg had not paid Peel for the merchandise purchased.
- Stagg's 1987 net income was $580,000. Peel's 1987 income before considering equity in Stagg's net income was $890,000.
- The balances in retained earnings at December 31, 1986, were $2,506,000 and $820,000 for Peel and Stagg, respectively.

Required:

Go to page AP-175 and remove tear-out worksheet.

a. Complete the tear-out worksheet to prepare a consolidated balance sheet of Peel, Inc., and its subsidiary, Stagg, Inc., at December 31, 1987. A formal consolidated balance sheet and journal entries are not required. Include the completed tear-out worksheet in the proper sequence with other answer sheets.

b. Prepare a formal consolidated statement of retained earnings for the year ended December 31, 1987.

1N88
Number 5 (Tear-out Worksheet)

Candidate's No. ____________
State ____________
Question No. 5 **Page** ____________

Peel, Inc. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
December 31, 1987

	Peel, Inc.	*Stagg, Inc.*	*Adjustments & Eliminations* Debit	*Adjustments & Eliminations* Credit	*Consolidated Balance*
Assets:					
Cash	$ 925,000	$ 300,000			
Accounts and other receivables	2,140,000	835,000			
Inventories	2,310,000	1,045,000			
Land	600,000	330,000			
Depreciable assets, net	4,525,000	1,980,000			
Investment in Stagg, Inc.	2,430,000				
Long-term investments and other assets	865,000	385,000			
	$13,795,000	$4,875,000			
Liabilities and stockholders' equity:					
Accounts payable and other current liabilities	$2,465,000	$1,145,000			
Long-term debt	1,900,000	1,300,000			
Common stock, $25 par value	3,200,000	1,000,000			
Additional paid-in capital	1,850,000	190,000			
Retained earnings	4,380,000	1,240,000			
	$13,795,000	$4,875,000			

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

1M89
Number 5 (Estimated time —— 40 to 50 minutes)

At December 31, 1987, Poe Corp. properly reported as current assets the following marketable equity securities:

Axe Corp., 1,000 shares, $2.40 convertible preferred stock	$ 40,000
Purl Inc., 6,000 shares of common stock	60,000
Day Co., 2,000 shares of common stock	55,000
Marketable equity securities at cost	155,000
Less valuation allowance	7,000
Marketable equity securities at market value	$148,000

On January 2, 1988, Poe purchased 100,000 shares of Scott Corp. common stock for $1,700,000, representing 30% of Scott's outstanding common stock and an underlying equity of $1,400,000 in Scott's net assets on January 2. Poe, which had no other financial transactions with Scott during 1988, amortizes goodwill over a 40-year period. As a result of Poe's 30% ownership of Scott, Poe has the ability to exercise significant influence over Scott's financial and operating policies.

During 1988, Poe disposed of the following securities:

- January 18 — sold 2,500 shares of Purl for $13 per share.
- June 1 — sold 500 shares of Day, after a 10% stock dividend was received, for $21 per share.
- October 1 — converted 500 shares of Axe's preferred stock into 1,500 shares of Axe's common stock, when the market price was $60 per share for the preferred stock and $21 per share for the common stock.

The following 1988 dividend information pertains to stock owned by Poe:

- February 14 — Day issued a 10% stock dividend, when the market price of Day's common stock was $22 per share.
- April 5 and October 5 — Axe paid dividends of $1.20 per share on its $2.40 preferred stock, to stockholders of record on March 9 and September 9, respectively. Axe did not pay dividends on its common stock during 1988.
- June 30 — Purl paid a $1.00 per share dividend on its common stock.
- March 1, June 1, September 1, and December 1 — Scott paid quarterly dividends of $0.50 per share on each of these dates. Scott's net income for the year ended December 31, 1988 was $1,200,000.

At December 31, 1988, Poe's management intended to hold Scott's stock as a long-term investment, with the remaining investments being considered as temporary. Market prices per share of the marketable equity securities were as follows:

	At December 31,	
	1988	*1987*
Axe Corp. — preferred	$56	$42
Axe Corp. — common	20	18
Purl, Inc. — common	11	11
Day Co. — common	22	20
Scott Corp. — common	16	18

All of the foregoing stocks are listed on major stock exchanges. Declines in market value from cost would not be considered permanent.

Required:

a. Prepare a schedule of Poe's *current* marketable equity securities at December 31, 1988, including any information necessary to determine the related valuation allowance and unrealized gains and losses.

b. Prepare a schedule to show the carrying amount of Poe's *noncurrent* marketable equity securities at December 31, 1988.

c. Prepare a schedule showing all revenue, gains, and losses (realized and unrealized) relating to Poe's investments for the year ended December 31, 1988.

B. Receivables and Accruals

1M92
Number 4 (Estimated time —— 45 to 55 minutes)

Number 4 consists of two unrelated parts.*

Number 4(b)

Sigma Co. began operations on January 1, 1990. On December 31, 1990, Sigma provided for uncollectible accounts based on 1% of annual credit sales. On January 1, 1991, Sigma changed its method of determining its allowance for uncollectible accounts by applying certain percentages to the accounts receivable aging as follows:

Days past invoice date	*Percent deemed to be uncollectible*
0 - 30	1
31 - 90	5
91 - 180	20
Over 180	80

In addition, Sigma wrote off all accounts receivable that were over one year old. The following additional information relates to the years ended December 31, 1991, and 1990:

	1991	*1990*
Credit sales	$3,000,000	$2,800,000
Collections	2,915,000	2,400,000
Accounts written off	27,000	None
Recovery of accounts previously written off	7,000	None
Days past invoice date at 12/31		
0 - 30	300,000	250,000
31 - 90	80,000	90,000
91 - 180	60,000	45,000
Over 180	25,000	15,000

Required:

a. Prepare a schedule showing the calculation of the allowance for uncollectible accounts at December 31, 1991.

b. Prepare a schedule showing the computation of the provision for uncollectible accounts for the year ended December 31, 1991.

*The item omitted can be found in another Content Specification Group.

1M88

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

Among the account balances of Rowe Corp. at December 31, 1986, are the following:

Patent, net of accumulated patent amortization	$245,000
Installment contract receivable, including current portion	720,000

In its year-end financial statements, Rowe reports as other noncurrent assets all assets that are not classified as property, plant, and equipment or as current assets. Relevant transactions and other information for 1987 were as follows:

- The patent was purchased from Lake Co. for $315,000 on September 1, 1983. On that date the remaining legal life was 15 years, which was also determined to be the useful life.
- The installment contract receivable represents the balance of the consideration received from the sale of a factory building to Pitt Co. on March 31, 1985, for $1,200,000. Pitt made a $300,000 down payment and signed a five-year 13% note for the $900,000 balance. The first of equal annual principal payments of $180,000 was received on March 31, 1986, together with interest to that date. The note is collateralized by the factory building with a fair value of $1,000,000 at December 31, 1986, and December 31, 1987. The 1987 payment was received on time.
- On January 2, 1987, Rowe purchased a trademark from Kerr Corp. for $250,000. Rowe considers the life of the trademark to be indefinite. The trademark will be amortized over the maximum period allowable.
- On May 1, 1987, Rowe sold the patent to Strand Co. in exchange for a $500,000 noninterest bearing note due on May 1, 1990. There was no established exchange price for the patent, and the note had no ready market. The prevailing rate of interest for a note of this type at May 1, 1987 was 14%. The present value of 1 for three periods at 14% is 0.675. The collection of the note receivable from Strand is reasonably assured.
- On July 1, 1987, Rowe paid $1,880,000 for 75,000 shares of Black Corp.'s common stock, which represented a 25% investment in Black. The fair value of all of Black's identifiable assets net of liabilities equals their carrying amount of $6,400,000. Rowe has the ability to exercise significant influence over Black's operating and financial policies. Rowe amortizes goodwill over a 40-year period. The market price of Black's common stock on December 31, 1987 was $26.50 per share.
- Black reported net income and paid dividends of:

	Net income	*Dividends per share*
Six months ended 6/30/87	$576,000	None
Six months ended 12/31/87	704,000	$2.00
(Dividend was paid 11/30/87)		

- Rowe and Black had no other intercompany transactions.

Required:

a. Prepare a separate schedule of changes for each of the other noncurrent asset accounts during 1987.

b. Prepare a schedule showing the revenues, gains, and expenses relating to Rowe's other noncurrent assets for the year ended December 31, 1987.

D. Property, Plant, and Equipment Owned or Leased

1N89

Number 4 (Estimated time —— 45 to 55 minutes)

Nan Co.'s property, plant, and equipment and accumulated depreciation and amortization balances at December 31, 1987 are:

	Cost	*Accumulated Depreciation*
Land	$ 275,000	——
Buildings	2,800,000	$ 672,900
Machinery and equipment	1,380,000	367,500
Automobiles and trucks	210,000	114,326
Leasehold improvements	432,000	108,000
Totals	$5,097,000	$1,262,726

Additional information follows:

Depreciation and amortization methods and useful lives

Buildings — 150% declining balance; 25 years.
Machinery and equipment — straight-line; 10 years.
Automobiles and trucks — 150% declining balance; five years, all acquired after 1985.
Leasehold improvements — straight-line.
Depreciation is computed to the nearest month.

Salvage values of depreciable assets are immaterial except for automobiles and trucks which have estimated salvage values equal to 15% of cost.

Other additional information

- Nan entered into a twelve-year operating lease starting January 1, 1985. The leasehold improvements were completed on December 31, 1984 and the facility was occupied on January 1, 1985.
- On January 6, 1988, Nan completed its self-construction of a building on its own land. Direct costs of construction were $1,095,000. Construction of the building required 15,000 direct labor hours. Nan's construction department has an overhead allocation system for outside jobs based on an activity denominator of 100,000 direct labor hours, budgeted fixed costs of $2,500,000, and budgeted variable costs of $27 per direct labor hour.
- On July 1, 1988, machinery and equipment were purchased at a total invoice cost of $325,000. Additional costs of $23,000 to rectify damage on delivery and $18,000 for concrete embedding of machinery were incurred. A wall had to be demolished to enable a large machine to be moved into the plant. The wall demolition cost $7,000, and rebuilding of the wall cost $19,000.
- On August 30, 1988, Nan purchased a new automobile for $25,000.
- On September 30, 1988, a truck with a cost of $48,000 and a carrying amount of $30,000 on December 31, 1987 was sold for $23,500.
- On November 4, 1988, Nan purchased a tract of land for investment purposes for $700,000. Nan thinks it might use the land as a potential future building site.
- On December 20, 1988, a machine with a cost of $17,000, a carrying amount of $2,975 on date of disposition, and a market value of $4,000 was given to a corporate officer in partial liquidation of a debt.

Required: Detach the tear-out worksheet on page AP-180.

a. Analyze the changes in each of the property, plant, and equipment accounts during 1988 by completing Schedule No. 1.

b. 1. For each asset category, prepare a schedule showing calculations for depreciation or amortization expense for the year ended December 31, 1988. Round computations to the nearest whole dollar.

2. Analyze the changes in accumulated depreciation and amortization by completing Schedule No. 2.

c. Prepare a schedule showing gain or loss on disposition of property, plant, and equipment.

1N89
Number 4 (Tear-out Worksheet)

Candidate's No. ______________
State ______________
Question No. 4 **Page** ______________

a.

Schedule 1

Nan Co.
ANALYSIS OF CHANGES IN PROPERTY, PLANT, AND EQUIPMENT
For the Year Ended December 31, 1988

	Balance 12/31/87	*Increase*	*Decrease*	*Balance 12/31/88*
Land	$ 275,000			
Buildings	2,800,000			
Machinery and equipment	1,380,000			
Automobiles and trucks	210,000			
Leasehold improvements	432,000			
Totals	$5,097,000			

b. 2.

Schedule 2

Nan Co.
ANALYSIS OF CHANGES IN ACCUMULATED DEPRECIATION AND AMORTIZATION
For the Year Ended December 31, 1988

	Balance 12/31/87	*Increase*	*Decrease*	*Balance 12/31/88*
Buildings	$ 672,900			
Machinery and equipment	367,500			
Automobiles and trucks	114,326			
Leasehold improvements	108,000			
Totals	$1,262,726			

1N88

Number 4 (Estimated time — — 45 to 55 minutes)

At December 31, 1986, Cord Company's plant asset and accumulated depreciation and amortization accounts had balances as follows:

Category	*Plant asset*	*Accumulated depreciation and amortization*
Land	$ 175,000	$ —
Buildings	1,500,000	328,900
Machinery and equipment	1,125,000	317,500
Automobiles and trucks	172,000	100,325
Leasehold improvements	216,000	108,000
Land improvements	—	—

Depreciation methods and useful lives

Buildings — 150% declining balance; 25 years.
Machinery and equipment — Straight-line; 10 years.
Automobiles and trucks — 150% declining balance; five years, all acquired after 1983.
Leasehold improvements — Straight-line.
Land improvements — Straight-line.
Depreciation is computed to the nearest month.
The salvage values of the depreciable assets are immaterial.

Transactions during 1987 and other information

- On January 6, 1987, a plant facility consisting of land and building was acquired from King Corp. in exchange for 25,000 shares of Cord's common stock. On this date, Cord's stock had a market price of $50 a share. Current assessed values of land and building for property tax purposes are $187,500 and $562,500, respectively.

- On March 25, 1987, new parking lots, streets, and sidewalks at the acquired plant facility were completed at a total cost of $192,000. These expenditures had an estimated useful life of 12 years.

- The leasehold improvements were completed on December 31, 1983, and had an estimated useful life of eight years. The related lease, which would have terminated on December 31, 1989, was renewable for an additional four-year term. On April 29, 1987, Cord exercised the renewal option.

- On July 1, 1987, machinery and equipment were purchased at a total invoice cost of $325,000. Additional costs of $10,000 for delivery and $50,000 for installation were incurred.

- On August 30, 1987, Cord purchased a new automobile for $12,500.

- On September 30, 1987, a truck with a cost of $24,000 and a carrying amount of $9,100 on date of sale was sold for $11,500. Depreciation for the 9 months ended September 30, 1987 was $2,650.

- On November 4, 1987, Cord purchased for $350,000 a tract of land as a potential future building site.

- On December 20, 1987, a machine with a cost of $17,000 and a carrying amount of $2,975 at date of disposition was scrapped without cash recovery.

Required:

a. Prepare a schedule analyzing the changes in each of the plant asset accounts during 1987. This schedule should include columns for beginning balance, increase, decrease and ending balance for each of the plant asset accounts. **Do not analyze changes in accumulated depreciation and amortization accounts.**

b. For each asset category, prepare a schedule showing depreciation or amortization expense for the year ended December 31, 1987. **Round computations to the nearest whole dollar.**

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

1M92
Number 5 (Estimated time —— 40 to 50 minutes)

The following is the long-term liabilities section of Tempo Co.'s December 31, 1990, balance sheet:

Long-term liabilities:

Note payable — bank; 15 principal payments of $5,000, plus 10% interest due annually on September 30	$75,000	
Less current portion	5,000	$ 70,000
Capital lease obligation — 16 payments of $9,000 due annually on January 1	$76,600	
Less current portion	1,340	75,260
Deferred income tax liability		15,750
Total long-term liabilities		$161,010

- Tempo's incremental borrowing rate on the date of the lease was 11% and the lessor's implicit rate, which was known by Tempo, was 10%.
- The only difference between Tempo's taxable income and pretax accounting income is depreciation on a machine acquired on January 1, 1990, for $250,000. The machine's estimated useful life is five years, with no salvage value. Depreciation is computed using the straight-line method for financial reporting purposes and the MACRS method for tax purposes. Depreciation expense for tax and financial reporting purposes for 1991 through 1994 is as follows:

Year	*Tax depreciation*	*Financial depreciation*	*Tax depreciation over (under) financial depreciation*
1991	$80,000	$50,000	$30,000
1992	40,000	50,000	(10,000)
1993	35,000	50,000	(15,000)
1994	30,000	50,000	(20,000)

The enacted federal income tax rates are 30% for 1990 and 1991, and 35% for 1992 through 1994.

- Included in Tempo's December 1990, balance sheet was a deferred tax asset of $9,000.
- For the year ended December 31, 1991, Tempo's income before income taxes was $430,000.
- On July 1, 1991, Tempo received proceeds of $459,725 from a $500,000 bond issuance. The bonds mature in 30 years and interest of 11% is payable each January 1 and July 1. The bonds were issued at a price to yield the investors 12%. Tempo uses the effective interest method to amortize the bond discount.

Required:

a. Prepare a schedule showing Tempo's income before income taxes, current income tax expense, deferred income tax expense, and net income. Show supporting calculations for current and deferred income tax amounts.

b. Prepare a schedule showing the calculation of Tempo's interest expense for the year ended December 31, 1991.

c. Prepare the long-term liabilities section of Tempo's December 31, 1991, balance sheet. Show supporting calculations.

2N88
Number 4 (Estimated time —— 45 to 55 minutes)

Lino Corporation's liability account balances at December 31, 1986 included the following:

Note payable to bank	$800,000
Liability under capital lease	280,000
Deferred income taxes	100,000

Additional information:

- The note payable, dated October 1, 1986, bears interest at an annual rate of 10% payable semiannually on April 1 and October 1. Principal payments are due annually on October 1 in four equal installments.
- The capital lease is for a 10-year period beginning December 31, 1981. Equal annual payments of $100,000 are due on December 31 of each year. The 16% interest rate implicit in the lease is known by Lino. At December 31, 1986, the present value of the four remaining lease payments discounted at 16% was $280,000.
- Deferred income taxes are provided in recognition of timing differences between financial statement and income tax reporting of depreciation. For the year ended December 31, 1987, depreciation per tax return exceeded book depreciation by $50,000. Lino's income tax rate for 1987 was 30%.
- On July 1, 1987, Lino issued $1,000,000 face amount of 10-year, 10% bonds for $750,000, to yield 15%. Interest is payable annually on July 1. Bond discount is amortized by the interest method.
- All required principal and interest payments were made on schedule in 1987.

Required:

a. Prepare the long-term liabilities section of Lino's balance sheet at December 31, 1987.

b. Prepare a schedule showing interest expense that should appear in Lino's income statement for the year ended December 31, 1987.

1M88
Number 4 (Estimated time —— 45 to 55 minutes)

Fay, Inc. finances its capital needs approximately one-third from long-term debt and two-thirds from equity. At December 31, 1986, Fay had the following liability and equity account balances:

11% Debenture bonds payable, face amount	$5,000,000
Premium on bonds payable	352,400
Common stock	8,000,000
Additional paid-in capital	2,295,000
Retained earnings	2,465,000
Treasury stock, at cost	325,000

Transactions during 1987 and other information relating to Fay's liabilities and equity accounts were as follows:

- The debenture bonds were issued on December 31, 1984, for $5,378,000 to yield 10%. The bonds mature on December 31, 1999. Interest is payable annually on December 31. Fay uses the interest method to amortize bond premium.
- Fay 's common stock shares are traded on the over-the-counter market. At December 31, 1986, Fay had 2,000,000 authorized shares of $10 par common stock.
- On January 15, 1987, Fay reissued 15,000 of its 25,000 shares of treasury stock for $225,000. The treasury stock had been acquired on February 28, 1986.
- On March 2, 1987, Fay issued a 5% stock dividend on all issued shares. The market price of Fay's common stock at time of issuance was $14 per share.
- On November 1, 1987, Fay borrowed $4,000,000 at 9%, evidenced by an unsecured note payable to United Bank. The note is payable in five equal annual principal installments of $800,000. The first principal and interest payment is due on November 1, 1988.
- On December 31, 1987, Fay owned 10,000 shares of Ryan Corp.'s common stock, which represented a 1% ownership interest. Fay accounts for this marketable equity investment as a long-term investment. The stock was purchased on May 1, 1986, at $20 per share. The market price was $21 per share on December 31, 1986, and $18 per share on December 31, 1987.
- Fay's net income for 1987 was $2,860,000.

1M88
Number 4 (cont.)

Required (Include formal schedules of supporting computations with each item referenced to correspond with the items in the solution):

a. Prepare the long-term liabilities section of Fay's December 31, 1987 balance sheet, including all disclosures applicable to each obligation.

b. Prepare the stockholders' equity section of Fay's December 31, 1987 balance sheet.

c. Prepare a schedule showing interest expense for the year ended December 31, 1987.

VII. Cost Accumulation, Planning, and Control

2N91
Number 4 (Estimated time —— 45 to 55 minutes)

Tredoc Co. is engaged in the business of seasonal tree-spraying and uses chemicals in its operations to prevent disease and bug-infestation. Employees are guaranteed 165 hours of work per month at $8 per hour and receive a bonus equal to 75% of their net favorable direct labor efficiency variance. The efficiency variance represents the difference between actual time consumed in spraying a tree and the standard time allowed for the height of the tree (specified in feet), multiplied by the $8 standard hourly wage rate. For budgeting purposes, there is a standard allowance of one hour per customer for travel, setup, and clearup time. However, since several factors are uncontrollable by the employee, this one-hour budget allowance is excluded from the bonus calculation. Employees are responsible for keeping their own daily timecards.

Chemical usage should vary directly with the tree-footage sprayed. Variable overhead includes costs that vary directly with the number of customers, as well as costs that vary according to tree-footage sprayed. Customers pay a service charge of $10 per visit and $1 per tree-foot sprayed.

The standard static budget and actual results for June are as follows:

			Static budget			*Actual results*
Service calls	(200 customers)		$ 2,000	(210 customers)		$ 2,100
Footage sprayed	(18,000 feet)		18,000	(21,000 feet)		21,000
Total revenues			20,000			23,100
Chemicals	(1,800 gallons)		4,500	(2,400 gallons)		5,880
Direct labor:						
Travel, setup, and clearup	(200 hours)	$1,600		(300 hours)	$2,400	
Tree-spraying	(900 hours)	7,200		(910 hours)	7,280	
Total direct labor			8,800			9,680
Overhead:						
Variable based on number of customers		1,200				
Variable based on tree-footage		1,800				
Fixed		2,000				
Total overhead			5,000			5,400
Total costs			18,300			20,960
Gross profit before bonus			$ 1,700			$ 2,140

July's demand is expected to be in excess of June's and may be met by either paying a 25% overtime premium to current employees or by hiring an additional employee. A new employee will cause fixed costs to increase by $100 per month. The potential increased demand may be estimated by considering the impact of increases of 20 and 30 customers, with probabilities of 70% and 30%, respectively.

Required:

a. Compute the following for June:
1. Direct materials price variance.
2. Direct materials usage (efficiency) variance.
3. Direct labor travel, setup, and clearup variance.
4. Direct labor bonus.
5. Overhead spending (flexible budget) variance.

Indicate whether each variance is favorable or unfavorable.

b. Assume that Tredoc accepts all orders for services in July. Should Tredoc hire an additional employee? Provide supporting computations based on standard cost.

2M91
Number 5 (Estimated time —— 40 to 50 minutes)

Spara Corp. is considering the various benefits that may result from the shortening of its product cycle by changing from the company's present manual system to a computer-aided design/computer-aided manufacturing (CAD/CAM) system. The proposed system can provide productive time equivalency close to the 20,000 hours currently available with the manual system. The incremental annual out-of-pocket costs of maintaining the manual system are $20 per hour.

The incremental annual out-of-pocket costs of maintaining the CAD/CAM system are estimated to be $200,000, with an initial investment of $480,000 in the proposed system. The estimated useful life of this system is six years. For tax purposes, assume a level accelerated cost recovery with a full year allowable in each year. The tax rate is expected to remain constant at 30% over the life of the project. Spara requires a minimum after-tax return of 20% on projects of this type. Full capacity will be utilized.

Required:

a. Compute the relevant annual after-tax cash flows related to the CAD/CAM project.

b. Based on the computation in **a.** above, compute the following on an after-tax basis:
1. Payback period for recovery of investment.
2. Internal rate of return (use the appropriate table from page AP-186).
3. Net present value (use the appropriate table from page AP-186).
4. Excess present value index (profitability index).

TABLE 1

Compound Amount of $1.00 (The Future Value of $1.00)
$S = P(1 + r)^n$. In this table P = $1.00.

PERIODS	4%	6%	8%	10%	12%	14%	16%	18%	20%	22%	24%	26%
1	1.040	1.060	1.080	1.100	1.120	1.140	1.160	1.180	1.200	1.220	1.240	1.260
2	1.082	1.124	1.166	1.210	1.254	1.300	1.346	1.392	1.440	1.488	1.538	1.588
3	1.125	1.191	1.260	1.331	1.405	1.482	1.561	1.643	1.728	1.816	1.907	2.000
4	1.170	1.262	1.360	1.464	1.574	1.689	1.811	1.939	2.074	2.215	2.364	2.520
5	1.217	1.338	1.469	1.611	1.762	1.925	2.100	2.288	2.488	2.703	2.932	3.176
6	1.265	1.419	1.587	1.772	1.974	2.195	2.436	2.700	2.986	3.297	3.635	4.002

2M91
Number 5 (cont.)

TABLE 2

Present Value of $1.00

$P = \frac{S}{(1 + r)^n}.$ In this table S = $1.00.

PERIODS	4%	6%	8%	10%	12%	14%	16%	18%	20%	22%	24%	26%
1	0.962	0.943	0.926	0.909	0.893	0.877	0.862	0.847	0.833	0.820	0.806	0.794
2	0.925	0.890	0.857	0.826	0.797	0.769	0.743	0.718	0.694	0.672	0.650	0.630
3	0.889	0.840	0.794	0.751	0.712	0.675	0.641	0.609	0.579	0.551	0.524	0.500
4	0.855	0.792	0.735	0.683	0.636	0.592	0.552	0.516	0.482	0.451	0.423	0.397
5	0.822	0.747	0.681	0.621	0.567	0.519	0.476	0.437	0.402	0.370	0.341	0.315
6	0.790	0.705	0.630	0.564	0.507	0.456	0.410	0.370	0.335	0.303	0.275	0.250

TABLE 3

Compound Amount of Annuity of $1.00 in Arrears* (Future Value of Annuity)

$$S_n = \frac{(1 + r)^n - 1}{r}$$

PERIODS	4%	6%	8%	10%	12%	14%	16%	18%	20%	22%	24%	26%
1	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
2	2.040	2.060	2.080	2.100	2.120	2.140	2.160	2.180	2.200	2.220	2.240	2.260
3	3.122	3.184	3.246	3.310	3.374	3.440	3.506	3.572	3.640	3.708	3.778	3.848
4	4.246	4.375	4.506	4.641	4.779	4.921	5.066	5.215	5.368	5.524	5.684	5.848
5	5.416	5.637	5.867	6.105	6.353	6.610	6.877	7.154	7.442	7.740	8.048	8.368
6	6.633	6.975	7.336	7.716	8.115	8.536	8.977	9.442	9.930	10.442	10.980	11.544

TABLE 4

Present Value of Annuity of $1.00 in Arrears*

$$P_n = \frac{1}{r} \left| 1 \frac{1}{(1 + r)^n} \right|$$

PERIODS	4%	6%	8%	10%	12%	14%	16%	18%	20%	22%	24%	26%
1	0.962	0.943	0.926	0.909	0.893	0.877	0.862	0.847	0.833	0.820	0.806	0.794
2	1.886	1.833	1.783	1.736	1.690	1.647	1.605	1.566	1.528	1.492	1.457	1.424
3	2.775	2.673	2.577	2.487	2.402	2.322	2.246	2.174	2.106	2.042	1.981	1.923
4	3.630	3.465	3.312	3.170	3.037	2.914	2.798	2.690	2.589	2.494	2.404	2.320
5	4.452	4.212	3.993	3.791	3.605	3.433	3.274	3.127	2.991	2.864	2.745	2.635
6	5.242	4.917	4.623	4.355	4.111	3.889	3.685	3.498	3.326	3.167	3.020	2.885

*Payments (or receipts) at the end of each period.

2N90

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

Lond Co. produces joint products Jana and Reta, together with byproduct Bynd. Jana is sold at split-off, whereas Reta and Bynd undergo additional processing. Production data pertaining to these products for the year ended December 31, 1989 were as follows:

	Jana	*Reta*	*Bynd*	*Total*
Joint costs				
Variable				$ 88,000
Fixed				148,000
Separable costs				
Variable		$120,000	$3,000	123,000
Fixed		90,000	2,000	92,000
Production in pounds	50,000	40,000	10,000	100,000
Sales price per pound	$4.00	$7.50	$1.10	

There were no beginning or ending inventories. No materials are spoiled in production. Variable costs change in direct proportion to production volume. Bynd's net realizable value is deducted from joint costs. Joint costs are allocated to joint products to achieve the same gross margin percentage for each joint product.

Although 1989 performance could be repeated for 1990, Lond is considering possible operation of the plant at full capacity of 120,000 pounds. The relative proportions of each product's output with respect to cost behavior and production increases would be unchanged. Market surveys indicate that prices of Jana and Bynd would have to be reduced to $3.40 and $0.90, respectively. Reta's expected price decline cannot be determined.

Required:

a. Prepare the following schedules for Lond Co. for the year ended December 31, 1989:

1. Total gross margin.
2. Allocation of joint costs to Jana and Reta.
3. Separate gross margins for Jana and Reta.

b. Compute Lond's breakeven point in pounds for the year ended December 31, 1989.

c. Prepare the following schedules for Lond Co. for the year ending December 31, 1990:

1. Projected production in pounds for each product at full capacity.
2. Differential revenues (excluding Reta).
3. Differential costs.
4. Sales price required per pound of Reta in order for Lond to achieve the same gross margin as that for 1989.

2M90
Number 5 (Estimated time — — 40 to 50 minutes)

Lane College is developing schedules for its overall budget projection for the 1990–91 academic year. Relevant 1989–90 data include:

	Undergraduates	*Graduates*
Enrollment	4,200	1,300
Average number of credit hours carried each year per student	30	24
Average number of students per class	25	14
Average faculty teaching load in credit hours per year (number of classes taught multiplied by 3 credit hours per class)	(8×3) 24	(6×3) 18
Average faculty salary and benefits	$50,000	$60,000
Tuition per credit hour (no other fees required)	$ 200	$ 300

Changes projected for 1990–91 and additional information:

1. Enrollments are expected to increase by 5 percent for both undergraduate and graduate programs.
2. Average faculty salary and benefits are expected to increase by 3 percent.
3. Lane has not previously used graduate students for teaching undergraduates, but will do so for 1990–91. All of the projected increased undergraduate enrollment will be taught by graduate students. Lane will recruit these graduate teaching assistants (TA's) in addition to the 5 percent student increase indicated. Each TA will carry half an average graduate student load and half an average faculty teaching load. TA's will receive a full remission of tuition fees and $10,000 in salary and benefits. For budgeting purposes, the tuition remission is considered both a tuition revenue and a tuition scholarship.
4. Non-faculty costs (excluding scholarships) for 1990–91 are to be budgeted by fixed and variable elements derived from estimates of cost at the following two levels of registration:

Total student credit hours (both schools)	140,000	180,000
Total estimated non-faculty costs	$21,960,000	$22,320,000

Required:

a. Prepare the following 1990-91 budget schedules for each program:
1. Projected enrollment.
2. Projected student credit hours.
3. Projected number of full-time faculty and TA's.
4. Projected salaries and benefits for full-time faculty and TA's.
5. Projected tuition revenue.

b. 1. Calculate the fixed and variable elements in the non-faculty costs.
2. Calculate the budgeted non-faculty costs, including scholarships, for the 1990–91 academic year.

2M89

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

The following information pertains to the pricing and delivery functions of Tapa Wholesale Company:

Number of sales made to customers in 1988	20,000
Average number of items per sale in 1988	4
Number of sales projected for 1989	24,000
Average number of items per sale projected for 1989	5

Sales invoices are priced by clerks whose wage rate is \$6.00 per hour. Labor negotiations have resulted in a 10% increase in the hourly rate for 1989. It is expected that Tapa's pricing function will operate at the same level of productivity in 1989 as it did in 1988. Payroll tax rates and workers' compensation insurance rates will be the same in 1989 as in 1988. Prices for various items of supplies are expected to be the same in 1989 as in 1988.

The following costs were charged to Tapa's pricing function in 1988:

Variable:	
Wages	\$40,000
Payroll taxes	4,000
Workers' compensation insurance	2,000
Supplies	1,000
Total variable	47,000
Fixed	3,400
Total costs	\$50,400

Fixed costs are allocated equally to all units. Except for delivery costs, all variable costs vary directly with the number of items priced. Supplies increase in proportion to the increase in the number of items priced. Tapa sells three products: Arcil, Balo, and Cacha. Differences in size and weight among these products affect variable delivery costs. For example, truck capacity is 10 units of Arcil, or 5 units of Balo, or 4 units of Cacha. Units projected to be delivered in 1989 are as follows:

Arcil	60,000
Balo	40,000
Cacha	20,000
Total	120,000

Projected 1989 costs for the delivery function are as follows:

Variable	\$228,000
Fixed	30,000

Required:

a. Prepare the 1989 budget of all costs for Tapa's pricing function.

b. Prepare a schedule showing the 1989 standard delivery cost per unit of each of the three products sold by Tapa.

2N88
Number 5 (Estimated time —— 40 to 50 minutes)

Amar Supermarkets Corp. operates a chain of three retail stores in a state that permits municipalities to levy an income tax on businesses operating within their respective boundaries. The tax rate is uniform in all of the municipalities that levy the tax, and does not vary according to taxable income. Regulations provide that the tax is to be computed on income earned within the particular taxing municipality, after reasonable and consistent allocation of the corporation's overhead. Amar's overhead consists of expenses pertaining to the warehouse, central office, advertising, and delivery.

For the year ended December 31, 1987, operating results for each store, before taxes and allocation of corporation overhead, were as follows:

	Birch	*Maple*	*Spruce*	*Total*
Sales	$500,000	$400,000	$300,000	$1,200,000
Cost of sales	280,000	230,000	190,000	700,000
Gross margin	220,000	170,000	110,000	500,000
Local operating expenses				
Fixed	70,000	60,000	50,000	180,000
Variable	66,000	73,000	31,000	170,000
Totals	136,000	133,000	81,000	350,000
Income before corporation overhead and taxes	$ 84,000	$ 37,000	$ 29,000	$ 150,000

For the year ended December 31, 1987, corporation overhead was as follows:

Warehouse and delivery		
Warehouse depreciation	$10,000	
Warehouse operations	15,000	
Delivery	35,000	$ 60,000
Central office		
Advertising	$ 8,000	
Salaries	30,000	
Other	2,000	40,000
Total corporation overhead		$100,000

Delivery expenses vary with distances from the warehouse and numbers of deliveries to stores. Delivery statistics for 1987 are as follows:

Store	*Miles from warehouse*	*Number of deliveries*	*Delivery miles*
Birch	100	150	15,000
Maple	200	50	10,000
Spruce	25	200	5,000

Management has engaged a CPA firm to evaluate two corporation overhead allocation plans that are being considered, so that operating results under both plans can be compared. In addition, management has decided to expand one of the stores in a plan to increase sales by $80,000. The contemplated expansion is expected to increase local fixed operating costs by $8,000 and to require 10 additional deliveries from the warehouse. The CPA firm has been requested to furnish management with a recommendation as to which store should be selected for the prospective expansion.

Required:

a. Rounding off to the nearest whole percent, compute each store's income that would be subject to the municipal income tax under the following two plans:

Plan 1. Allocate all corporation overhead on the basis of sales.
Plan 2. Allocate central office salaries and other central office overhead equally to warehouse operations and to each store. Then, allocate the resulting warehouse operations costs, warehouse depreciation, and advertising to each store on the basis of sales. Finally, allocate delivery expenses to each store on the basis of delivery miles.

b. Compute each store's increase in relevant expenses, including delivery expenses, but before allocation of other corporation overhead and taxes as a result of the contemplated expansion. Determine which of the three stores should be selected for expansion to maximize corporate net income.

2M88
Number 5 (Estimated time —— 40 to 50 minutes)

Seco Corp., a wholesale supply company, engages independent sales agents to market the company's lines. These agents currently receive a commission of 20% of sales, but they are demanding an increase to 25% of sales made during the year ending December 31, 1989. Seco had already prepared its 1989 budget before learning of the agents' demand for an increase in commissions. The following pro forma income statement is based on this budget:

Seco Corp.
PRO FORMA INCOME STATEMENT
For the Year Ending December 31, 1989

Sales		$10,000,000
Cost of sales		6,000,000
Gross margin		4,000,000
Selling and administrative costs		
Commissions	$2,000,000	
All other costs (fixed)	100,000	2,100,000
Income before income tax		1,900,000
Income tax (30%)		570,000
Net income		$ 1,330,000

Seco is considering the possibility of employing its own salespersons. Three individuals would be required, at an estimated annual salary of $30,000 each, plus commissions of 5% of sales. In addition, a sales manager would be employed at a fixed annual salary of $160,000. All other fixed costs, as well as the variable cost percentages, would remain the same as the estimates in the 1989 pro forma income statement.

Required:

a. Compute Seco's estimated breakeven point in sales dollars for the year ending December 31, 1989 based on the pro forma income statement prepared by the company.

b. Compute Seco's estimated breakeven point in sales dollars for the year ending December 31, 1989 if the company employs its own salespersons.

c. Compute the estimated volume in sales dollars that would be required for the year ending December 31, 1989 to yield the same net income as projected in the pro forma income statement, if Seco continues to use the independent sales agents and agrees to their demand for a 25% sales commission.

d. Compute the estimated volume in sales dollars that would generate an identical net income for the year ending December 31, 1989, regardless of whether Seco employs its own salespersons or continues to use the independent sales agents and pays them a 25% commission.

VIII. Not-for-Profit and Governmental Accounting

2N91
Number 5 (Estimated time —— 40 to 50 minutes)

The following information pertains to Eden Township's construction and financing of a new administration center:

Estimated total cost of project	$9,000,000
Project financing:	
State entitlement grant	3,000,000
General obligation bonds:	
Face amount	6,000,000
Stated interest rate	6%
Issue date	December 1, 1990
Maturity date	November 30, 2000

During Eden's year ended June 30, 1991, the following events occurred that affect the capital projects fund established to account for this project:

July 1, 1990 — The capital projects fund borrowed $300,000 from the general fund for preliminary expenses.

July 9, 1990 — Engineering and planning costs of $200,000, for which no encumbrance had been recorded, were paid to Napp Associates.

December 1, 1990 — The bonds were sold at 101. Total proceeds were retained by the capital projects fund.

December 1, 1990 — The entitlement grant was formally approved by the state.

April 30, 1991 — A $7,000,000 contract was executed with Caro Construction Corp., the general contractors, for the major portion of the project. The contract provides that Eden will withhold 4% of all billings pending satisfactory completion of the project.

May 9, 1991 — $1,000,000 of the state grant was received.

June 10, 1991 — The $300,000 borrowed from the general fund was repaid.

June 30, 1991 — Progress billing of $1,200,000 was received from Caro.

Eden uses encumbrance accounting for budgetary control. Unencumbered appropriations lapse at the end of the year.

Required:

a. Prepare journal entries in the administration center capital projects fund to record the foregoing transactions.

b. Prepare the June 30, 1991, closing entries for the administration center capital projects fund.

c. Prepare the administration center capital projects fund balance sheet at June 30, 1991.

2M91
Number 4 (Estimated time —— 45 to 55 minutes)

Albury City was incorporated as a municipality and began operations on January 1, 1990. The budget approved by the City Council was recorded, but the cash basis was used in Albury's books for all 1990 transactions. Albury has decided to use encumbrance accounting. Albury's cash basis general fund trial balance at December 31, 1990, is presented below and in the tearout worksheet on page AP-186.

Debits	
Cash	$477,800
Expenditures	145,000
Estimated revenues	228,200
Total	$851,000

Credits	
Appropriations	$204,000
Revenues	216,800
Bonds payable	400,000
Premium on bonds payable	6,000
Fund balance	24,200
Total	$851,000

Additional information:

	Budgeted	*Actual*
Revenues		
Property taxes	205,200	$192,000
Licenses	14,800	15,800
Fines	8,200	9,000
Totals	$228,200	$216,800
Appropriations		
Services	$ 90,000	$ 77,000
Supplies	38,000	22,000
Equipment	76,000	46,000
Totals	$204,000	$145,000

It was estimated that 5% of the property taxes would not be collected. Accordingly, property taxes were levied to yield the budgeted amount of $205,200. Taxes of $192,000 had been collected by December 31, 1990, and it was expected that all remaining collectible taxes would be received by February 28, 1991.

Supplies of $8,000 and equipment of $20,000 were received, but the vouchers were unpaid at December 31, 1990. Purchase orders were still outstanding for supplies and equipment not yet received, in the amounts of $2,400 and $7,600, respectively.

It was decided to record the $3,400 physical inventory of supplies on hand at December 31, 1990. In conformity with a city ordinance, expenditures are based on purchases rather than usage.

On November 1, 1990, Albury issued 4% general obligation term bonds of $400,000 at 101½. Interest is payable each May 1 and November 1 until the maturity date of November 1, 2009. Cash from the bond premium is to be set aside and restricted for eventual retirement of bond principal. The bonds were issued to finance the construction of a firehouse, but no contracts had been executed by December 31, 1990.

Required:
Detach the tear-out worksheet on page AP-194, and complete this worksheet showing adjustments and distributions to the proper funds or account groups, before closing entries, in conformity with generally accepted accounting principles applicable to governmental entities. Formal adjusting entries are **not** required.

Turn in the tear-out worksheet in the proper sequence with other answer sheets.

2M91
Number 4 (Tear-out Worksheet)

Candidate's No. ____________
State ____________
Question No. 4 **Page** ____________

Albury City
WORKSHEET TO CORRECT TRIAL BALANCE
December 31, 1990

	Trial balance	Adjustments Debit	Adjustments Credit	General fund	Debt service fund	Capital projects fund	Account groups: General fixed assets	Account groups: General long-term debt
Debits:								
Cash	$477,800							
Expenditures	145,000							
Estimated revenues	228,200							
Totals	$851,000							
Credits:								
Appropriations	$204,000							
Revenues and other financing sources	216,800							
Bonds payable	400,000							
Premium on bonds payable	6,000							
Fund balance	24,200							
Totals	$851,000							

DETACH, COMPLETE, AND TURN IN THIS TEAR-OUT WORKSHEET IN THE PROPER SEQUENCE WITH OTHER ANSWER SHEETS.

2N89

Number 4 (Estimated time —— 45 to 55 minutes)

Children's Agency, a voluntary health and welfare organization, conducts two programs: Medical Services Program and Community Information Services Program. It had the following transactions during the year ended June 30, 1989:

1. Received the following contributions:

Unrestricted pledges	$800,000
Restricted cash	95,000
Building fund pledges	50,000
Endowment fund cash	1,000

2. Collected the following pledges:

Unrestricted	450,000
Building fund	20,000

3. Received the following unrestricted cash revenues:

From theatre party (net of direct costs)	12,000
Bequests	10,000
Membership dues	8,000
Interest and dividends	5,000

4. Program expenses incurred (processed through vouchers payable):

Medical services	60,000
Community information services	15,000

5. Services expenses incurred (processed through vouchers payable):

General administration	150,000
Fund raising	200,000

6. Fixed assets purchased with unrestricted cash 18,000

7. Depreciation of all buildings and equipment in the land, buildings, and equipment fund was allocated as follows:

Medical services program	4,000
Community information services program	3,000
General administration	6,000
Fund raising	2,000

8. Paid vouchers payable 330,000

Required: Detach the tear-out worksheet on page AP-196.

On the tear-out worksheet, record the journal entries (without explanations) for the preceding transactions. With credit amounts placed in parentheses, insert the amounts in the proper columns for each of the following funds:

Current Fund — Unrestricted
Current Fund — Restricted
Land, Buildings, and Equipment Fund
Endowment Fund

Number the journal entries to coincide with the transaction numbers indicated.

2N89
Number 4 (Tear-out Worksheet)

Candidate's No. ____________
State ____________
Question No. 4 **Page** ____________

Children's Agency
JOURNAL ENTRIES
For the Year Ended June 30, 1989

Account Title	*Current Fund*		*Land, Buildings, and Equipment Fund Dr. (Cr.)*	*Endowment Fund Dr. (Cr.)*
	Unrestricted Dr. (Cr.)	*Restricted Dr. (Cr.)*		

IX. Federal Taxation — Individuals, Estates, and Trusts

2M90
Number 4 (Estimated time —— 45 to 55 minutes)

The following information pertains to Earl Mayne (age 59) for the calendar year 1989:

Marital status

Earl's wife, Joan, died in June 1987. Earl and Joan filed a joint federal income tax return for 1987. Earl did **not** remarry.

Dependents who reside with Earl and are totally supported by Earl

Alex — Earl's stepson, age 5. Alex has no income of his own.
Mary — Joan's mother, age 90. Mary received social security benefits of $6,600 in 1989, which she deposited in her savings account and did **not** withdraw.

Cash received in 1989

Salary — employed as a computer analyst			
Gross amount		$60,000	
Amounts withheld			
Federal income tax	$10,000		
State income tax	2,000		
FICA tax	3,605		
Medical insurance premiums	1,000		
Life insurance premiums	600	17,205	
Net amount received			$42,795
Salary — employed as a part-time teacher			
Gross amount		$ 3,000	
Amounts withheld			
Federal income tax	$ 100		
FICA tax	225	325	
Net amount received			2,675
Sale of principal residence			
Gross sales price (sold for 100% cash)		$99,800	
State transfer tax	$ 998		
Legal fee	1,400	2,398	97,402
Gross rents from 5% interest in rental realty			1,200
Dividends on life insurance policy			410
Dividends on stocks of unrelated taxable domestic corporations			875
Proceeds from settlement of nonbusiness bad debt			350
Proceeds of life insurance policy on death of Earl's aunt			5,000
Interest on U.S. treasury notes			800

2M90
Number 4 (cont.)

Cash disbursed in 1989

Household and miscellaneous personal expenses	$45,000
State sales taxes substantiated by receipts	1,910
Estimated 1989 federal income tax payments	4,000
Fee paid to CPA for tax return preparation	500
Professional education courses required to maintain job skills	900
Membership dues to Society of Computer Analysts	250
Contribution to a national political party	200
Realty taxes on principal residence prior to sale	1,500
Share of realty taxes on 5%-owned rental realty	700
Share of maintenance on 5%-owned rental realty	1,300
State inheritance tax on bequest of stamp collection from aunt's estate	190
Premiums on life insurance policy	1,100
Driver's license for three-year term	36
Contributions to qualified charitable organizations	2,250

Additional information:

- Earl's basis for his principal residence (purchased in 1960 and sold in 1989) was $14,000. This was the only home ever owned by Earl or Joan. Earl does **not** intend to buy another home. Earl made the required election in his 1989 return to avail himself of the maximum applicable exclusion in order to minimize his 1989 taxable income.
- The rental realty in which Earl owns a 5% interest was purchased in 1988. Earl does **not** render any services in connection with this investment.
- The accumulated net premiums paid on Earl's life insurance policy have **not** been exceeded by dividends received on the policy.
- The nonbusiness bad debt arose in connection with a $2,500 loan made by Earl to a friend. The $2,150 unpaid balance of the loan is uncollectible.
- Earl's 1988 federal return showed a tax overpayment of $70, which Earl elected to credit to his 1989 estimated tax.
- Earl's 1988 state return showed no balance of tax due or overpayment.
- Personal exemptions and dependency exemptions are $2,000 each for 1989.
- The standard deductions for 1989 are as follows:

	Basic	*Additional*
Joint	$5,200	$600
Head of household	4,550	750
Single	3,100	750

Required:

a. State which one of the following tax rate schedules or tax tables is applicable for Earl's 1989 return: joint, head of household, or single.

b. Prepare a detailed schedule computing Earl Mayne's 1989 taxable income. Show each appropriate item separately in the schedule, and classify each item properly. Any possible alternative treatment should be resolved in a manner that will minimize 1989 taxable income. Round to the nearest dollar.

c. Assume that Earl Mayne's 1989 federal income tax is $10,082 before tax credits and payments. Compute the net amount of tax payable or net overpayment of tax.

2N89
Number 5 (Estimated time —— 40 to 50 minutes)

The following information pertains to Fred and Laura Shaw, a married couple filing a joint federal income tax return for the calendar year 1988:

Fred, age 73 — cash received in 1988			
Salary — employed as an industrial engineer			
Gross amount		$80,000	
Amounts withheld			
Federal income tax	$17,000		
State income tax	4,000		
FICA taxes	3,380		
Medical insurance premiums	1,200	25,580	
Net amount received			$54,420
Social security benefits			12,000
Dividends on life insurance policy (accumulated net premiums not exceeded)			400
Laura, age 61 — cash received in 1988			
Salary — from part-time employment			
Gross amount		$15,000	
Amounts withheld			
Federal income tax	$ 2,800		
State income tax	120		
FICA taxes	1,127	4,047	
Net amount received			10,953
Unemployment compensation benefits			600
Cash received jointly in 1988			
Proceeds from sale of stock (Bought in 1970 — basis $9,000)			2,500
Dividends from taxable domestic corporations			527
Interest on U.S. Government Savings Bonds			100
Total cash received			$81,500
Cash disbursed in 1988			
Household and miscellaneous personal expenses			$50,000
State sales taxes substantiated by receipts			1,900
Estimated 1988 federal income tax payments			2,000
Fee paid to CPA for tax return preparation			250
Unreimbursed business travel away from home overnight			900
Continuing professional education courses required to maintain job skills			700
Membership dues to Society of Industrial Engineers			150
Contribution to a national political party			200
Realty taxes on primary residence			3,000
Realty taxes on summer cottage			800
Mortgage interest on primary residence			2,300
Mortgage principal on primary residence			500
Mortgage interest on summer cottage (no payments on principal)			1,800
Total cash disbursed			$64,500

2N89
Number 5 (cont.)

Additional information:

- The 1987 joint federal income tax return showed a tax overpayment of $43, which the Shaws elected to credit to their 1988 estimated tax.
- The 1987 joint state income tax return showed no balance of tax due or overpayment.
- In June 1988, Fred donated 500 shares of stock of a listed corporation to a recognized charitable organization. Fred's basis for this stock, which was bought in 1975, was $1,100. Fair market value of this stock on the date of the donation was $1,400.
- In July 1988, the summer cottage, which was not insured, sustained fire damage. Information pertaining to this property is as follows:

Basis	$40,000
Fair market value immediately before the fire	66,000
Fair market value immediately after the fire	50,000

- The Shaws supported their daughter, Doris, who had been disabled since infancy, and who lived in the Shaw household. Doris had no income. She died on January 2, 1988.
- Personal exemptions and dependency exemptions are $1,950 each for 1988.
- The basic standard deduction is $5,000 and the additional standard deduction is $600 for 1988.

Required:

a. Prepare a detailed schedule computing Fred and Laura Shaw's joint taxable income for 1988. Show each appropriate item separately in the schedule, and classify each item properly. Any possible alternative treatment should be resolved in a manner that will minimize 1988 taxable income. Round to the nearest dollar.

b. Assume that Fred and Laura Shaw's 1988 federal income tax on their 1988 joint taxable income is $16,946 before tax credits and payments. Compute the net amount of tax payable or net overpayment of tax.

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

2M92
Number 5 (Estimated time —— 40 to 50 minutes)

Following is Ral Corp.'s condensed income statement, before federal income tax, for the year ended December 31, 1991:

Sales		$1,000,000
Cost of sales		700,000
Gross profit		300,000
Operating expenses		220,000
Operating income		80,000
Other income (loss):		
Interest	$ 5,200	
Dividends	19,200	
Net long-term capital loss	(6,400)	18,000
Income before federal income tax		$ 98,000

Additional information:

Interest arose from the following sources:	
U.S. Treasury notes	$ 3,000
Municipal arbitrage bonds	2,000
Other municipal bonds	200
Total interest	$ 5,200

Dividends arose from the following sources:

Taxable domestic corporation	Date stock acquired	Percent owned by Ral	
Clove Corp.	7-1-85	30.0	$ 7,000
Ramo Corp.	9-1-87	10.0	6,000
Sol Corp. (stock sold 1/10/92)	12-1-91	5.0	1,000
Real Estate Investment Trust	6-1-90	1.0	2,700
Mutual Fund Corp. (capital gains dividends only)	4-1-89	0.1	400
Money Market Fund (invests only in interest-paying securities)	3-1-88	0.1	2,100
Total dividends			$ 19,200

Operating expenses include the following:

Bonus of $5,000 paid to Ral's sales manager on January 31, 1992. This bonus was based on a percentage of Ral's 1991 sales and was computed on January 25, 1992, under a formula in effect in 1991.

Estimate of $10,000 for bad debts. Actual bad debts for the year amounted to $8,000. No pre-1987 bad debt reserve remained on Ral's books since January 1, 1987.

Keyman life insurance premiums of $4,000. Ral is the beneficiary of the policies.

State income taxes of $12,000.

During 1991, Ral made estimated federal income tax payments of $35,000. These payments were debited to prepaid tax expense on Ral's books.

Ral does **not** exercise significant influence over Clove and accordingly did **not** use the equity method of accounting for this investment.

Ral declared and paid dividends of $11,000 during 1991.

Corporate income tax rates are as follows:

Taxable income over	but not over	Pay	+ % on excess	Of the amount over—
$ 0–	$ 50,000	$ 0	15%	$ 0
50,000–	75,000	7,500	25	50,000
75,000–	100,000	13,750	34	75,000
100,000–	335,000	22,250	39	100,000
335,000–	....	113,900	34	335,000

Ral was not subject to the alternative minimum tax in 1991.

Required:

a. Prepare a schedule of Ral's 1991 taxable income.

b. Compute Ral's 1991 federal income tax and the amount of tax overpaid or payable.

c. Prepare a reconciliation of Ral's income per books with income per return.

2N90
Number 4 (Estimated time —— 45 to 55 minutes)

Esa, Inc., a wholesaler, commenced operations on January 2, 1989. Esa is an accrual basis, calendar-year corporation that made a timely and proper election to be treated as an S corporation.

Esa's income statement for the year ended December 31, 1989 is presented below and in the tear-out worksheet on page AP-198.

Sales		$500,000
Cost of goods sold		300,000
Gross profit		200,000
Operating expenses		
Compensation of officer	$90,000	
Uncollectible accounts	7,000	
Taxes	25,000	
Depreciation	14,000	
Contributions	5,000	
Employee benefit programs	19,000	
Amortization of organization costs	300	
Other	20,700	181,000
Operating income		19,000
Net rental revenue		18,000
Portfolio revenue		
Interest	5,600	
Dividends	3,000	
Short-term capital gain	9,000	17,600
Total income		$ 54,600

Additional information:

- The officer's compensation of $90,000 was received in 1989 by Carl Loren, Esa's president and sole stockholder.
- Esa used the "reserve" method in computing uncollectible accounts expense of $7,000. Actual customers' accounts receivable written off in 1989 because of uncollectibility amounted to $1,900.
- Included in the $25,000 expense for taxes are $400 in parking fines incurred while Esa's trucks were making deliveries to customers, and $2,200 in income taxes paid to a foreign country where Esa has a sales outlet.
- The depreciation of $14,000 was computed under the straight-line method for book purposes. For tax purposes, depreciation was also $14,000, including the full $10,000 expense deduction claimed by Esa under Section 179.
- The contributions of $5,000 were made to recognized charitable organizations.
- Included in the employee benefit programs of $19,000 are Loren's medical expenses amounting to $6,000.
- Esa's organization costs of $1,500 are being amortized over a period of 60 months.
- Included in the other operating expenses of $20,700 is insurance expense of $8,000 in connection with establishment of a reserve for self-insurance.
- The interest revenue of $5,600 was earned on U.S. government obligations.
- The dividends of $3,000 were received from unrelated taxable domestic corporations.
- The short-term capital gain of $9,000 was realized on the sale of an investment in an unrelated taxable domestic corporation.
- Esa's only payment to Loren during 1989 was Loren's salary of $90,000. No other distributions were made.

Required: Detach the tear-out worksheet on page AP-203.

a. Complete the tear-out worksheet to convert Esa's book amounts to Esa's tax return amounts and Loren's Schedule K-1 amounts for the year ended December 31, 1989.

b. State the due date for the filing of Esa's 1989 S Corporation Income Tax Return.

2N90
Number 4 (Tear-out Worksheet)

Candidate's No. ______
State ______
Question No. 4 **Page** ______

a.

Esa, Inc.
WORKSHEET TO CONVERT
BOOK AMOUNTS TO TAX RETURN AMOUNTS
For the Year Ended December 31, 1989

	Per books	*Adjustments*	*S Corporation tax return*	*Schedule K-1*
Income				
Sales	500,000			
Cost of goods sold	300,000			
Gross profit	200,000			
Deductions				
Compensation of officer	90,000			
Uncollectible accounts	7,000			
Taxes	25,000			
Depreciation	14,000			
Contributions	5,000			
Employee benefit programs	19,000			
Amortization of organization costs	300			
Other	20,700			
Total deductions	181,000			
Operating income	19,000			
Net rental revenue	18,000			
Portfolio revenue				
Interest	5,600			
Dividends	3,000			
Short-term capital gain	9,000			
Total income	54,600			

2M89

Number 4 (Estimated time — — 45 to 55 minutes)

The following adjusted accounts appeared in the records of Elm Corp., an accrual basis corporation, for the year ended December 31, 1988. Numbers in brackets refer to the items in *Additional information.*

Revenues and gains		
Net sales	$5,500,000	[1]
Dividends	10,000	[2]
Interest	4,000	[3]
Gain on sale of stock	6,000	[4]
Equity in earnings of Luz Partnership	50,000	[5]
Key-man life insurance proceeds	200,000	[6]
Tax refund	3,000	[7]
Total	5,773,000	
Cost and expenses		
Cost of goods sold	3,900,000	[8]
Salaries and wages	571,000	[9]
Doubtful accounts	15,000	[10]
Taxes	100,000	[11]
Interest	20,000	[12]
Contributions	175,000	[13]
Depreciation	90,000	[14]
Other	30,000	[15]
Federal income tax	193,000	[16]
Total	5,094,000	
Net income	$ 679,000	

Additional information:

[1] Trade accounts receivable at December 31, 1988 and at December 31, 1987 amounted to $300,000 and $180,000, respectively.

[2] Dividends were declared and paid in 1988 by an unrelated taxable domestic corporation whose securities are traded on a major stock exchange.

[3] Interest revenue comprises interest on municipal bonds issued in 1982 and purchased by Elm in the open market in 1988.

[4] Gain on sale of stock arose from the following purchase and sale of stock in an unrelated corporation listed on a major stock exchange:

Bought in 1980	Cost	$12,000
Sold in 1988	Proceeds of sale	18,000

[5] Elm owns 50% of Luz Partnership. The other 50% is owned by an unrelated individual. Luz reported the following tax information to Elm:

Elm's share of:	
Partnership ordinary income	$63,000
Net long-term capital loss	(13,000)

[6] Elm owned the key-man life insurance policy, paid the premiums, and was the direct beneficiary. The proceeds were collected on the death of Elm's controller.

[7] The tax refund arose from Elm's overpayment of federal income tax on the 1986 return.

[8] Cost of goods sold relates to Elm's net sales.

[9] Salaries and wages includes officers' compensation of $125,000.

[10] Doubtful accounts expense represents an addition to Elm's allowance for doubtful accounts based on an aging schedule whereby Elm "reserves" all accounts receivable over 120 days for book purposes. The balance in Elm's allowance for doubtful accounts was $142,000 at December 31, 1988. Actual bad debts written off in 1988 amounted to $9,000. Elm's allowance for doubtful accounts at December 31, 1986 (at the beginning of the first year of the tax law change) was $120,000.

[11] Taxes comprise payroll taxes and property taxes.

[12] Interest expense resulted from borrowing for working capital purposes.

[13] Contributions were all paid in 1988 to State University, specifically designated for the purchase of computers.

[14] Elm has always used straight-line depreciation for both book and tax purposes.

[15] Other expenses include premiums of $12,000 on the key-man life insurance policy covering the controller.

[16] Federal income tax is the amount estimated and accrued before preparation of the return.

Required:

Prepare a schedule of taxable income as it should appear on Elm's 1988 federal income tax return. Show all items required to be included in the return. Assume that the alternative minimum tax is less than the regular tax. Any possible optional treatment should be resolved in a manner that will minimize Elm's 1988 taxable income.

SELECTED PROBLEMS — UNOFFICIAL ANSWERS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1M91
Answer 4 (10 points)

a.

Kern, Inc.
LONG-TERM RECEIVABLES SECTION OF BALANCE SHEET
December 31, 1990

9% note receivable from sale of idle building, due in annual installments of $250,000 to May 1, 1992, less current installment	$250,000	[1]*
8% note receivable from officer, due December 31, 1992, collateralized by 5,000 shares of Kern, Inc., common stock with a fair value of $225,000	200,000	
Noninterest-bearing note from sale of patent, net of 10% imputed interest, due April 1, 1992	88,795	[2]
Installment contract receivable, due in annual installments of $88,332 to July 1, 1994, less current installment	219,668	[3]
Total long-term receivables	$758,463	

b.

Kern, Inc.
SELECTED BALANCE SHEET ACCOUNTS
December 31, 1990

Current portion of long-term receivables:		
Note receivable from sale of idle building	$250,000	[1]
Installment contract receivable	60,332	[3]
Total	$310,332	
Accrued interest receivable:		
Note receivable from sale of idle building	$30,000	[4]
Installment contract receivable	14,000	[5]
Total	$44,000	

*Numbers in brackets are keyed to explanations of amounts.

1M91
Answer 4 (cont.)

c.

Kern, Inc.
INTEREST REVENUE FROM LONG-TERM RECEIVABLES AND GAINS RECOGNIZED ON SALE OF ASSETS
For the year ended December 31, 1990

Interest revenue:		
Note receivable from sale of idle building	$52,500	[6]
Note receivable from sale of patent	6,195	[2]
Note receivable from officer	16,000	[7]
Installment contract receivable from sale of land	14,000	[5]
Total interest revenue	$88,695	
Gains recognized on sale of assets:		
Patent	$ 44,600	[8]
Land	100,000	[9]
Total gains recognized	$144,600	

Explanation of Amounts:

[1] Long-term portion of 9% note receivable at 12/31/90

Face amount, 5/1/89	$750,000
Less installment received 5/1/90	250,000
Balance, 12/31/90	500,000
Less installment due 5/1/91	250,000
Long-term portion, 12/31/90	$250,000

[2] Noninterest-bearing note, net of imputed interest at 12/31/90

Face amount, 4/1/90	$100,000
Less imputed interest [$100,000 − $82,600 ($100,000 × 0.826)]	17,400
Balance, 4/1/90	82,600
Add interest earned to 12/31/90 [$82,600 × 10% × 9/12]	6,195
Balance, 12/31/90	$ 88,795

[3]	Long-term portion of installment contract receivable at 12/31/90		
	Contract selling price, 7/1/90		$400,000
	Less cash down payment		120,000
	Balance, 12/31/90		280,000
	Less installment due 7/1/91 [$88,332 − $28,000 ($280,000 × 10%)]		60,332
	Long-term portion, 12/31/90		$219,668

[4]	Accrued interest — note receivable, sale of idle building at 12/31/90		
	Interest accrued from 5/1 to 12/31/90 [$500,000 × 9% × $^8/_{12}$]		$ 30,000

[5]	Accrued interest — installment contract at 12/31/90		
	Interest accrued from 7/1 to 12/31/90 [$280,000 × 10% × ½]		$ 14,000

[6]	Interest revenue — note receivable, sale of idle building, for 1990		
	Interest earned from 1/1 to 5/1/90 [$750,000 × 9% × $^4/_{12}$]		$ 22,500
	Interest earned from 5/1 to 12/31/90 [$500,000 × 9% × $^8/_{12}$]		30,000
	Interest revenue		$ 52,500

[7]	Interest revenue — note receivable, officer, for 1990		
	Interest earned 1/1 to 12/31/90 [$200,000 × 8%]		$ 16,000

[8]	Gain recognized on sale of patent			
	Stated selling price		$100,000	
	Less imputed interest		17,400	[2]
	Actual selling price		82,600	
	Less cost of patent (net)			
	Carrying value 1/1/90	$40,000		
	Less amortization 1/1 to 4/1/90 [$8,000 × ¼]	2,000	38,000	
	Gain recognized		$ 44,600	

[9]	Gain recognized on sale of land	
	Selling price	$400,000
	Less cost	300,000
	Gain recognized	$100,000

1M91
Answer 5 (10 points)

Cord Corp.
ADJUSTING JOURNAL ENTRIES
December 31, 1990
(Explanations not required)

	Dr.	Cr.
(1)		
Marketable equity securities	$ 30,000	
Realized gain on sale of marketable equity securities		$ 30,000 [a]
(2)		
Unrealized loss on marketable equity securities	13,000	
Allowance to reduce marketable equity securities to market value		13,000 [b]
(3)		
Cost of sales	66,000	
Inventories		66,000
(4)		
Property and equipment	48,000	
Income tax payable		14,400 [c]
Retained earnings		33,600 [c]
(5)		
Depreciation	8,000	
Accumulated depreciation		8,000 [d]
(6)		
Estimated loss from lawsuit	60,000	
Estimated liability from lawsuit		60,000
(7)		
Deferred pension cost	40,000	
Additional pension liability		40,000
(8)		
Deferred tax asset	21,900 [i]	
Income tax payable	13,200 [ii]	
Income tax expense		35,100 [iii]

	Dr.		Cr.	
Supporting Computations for Number 8				
Adjusted total income tax expense for 1990				
Income before income tax, as reported			$640,000	
Add adjustment increasing income				
Realized gain on sale of securities			30,000	[1]
Deduct adjustments decreasing income			670,000	
Increase cost of sales for inventory overstatement	$66,000			
Depreciation on pollution control devices	8,000		74,000	
Adjusted taxable income before income tax			$596,000	
Adjusted actual income tax expense ($596,000 × 30%)			$178,800	
Deferred income tax benefits — based on following temporary differences:				
Lawsuit expected to be settled in 1992	$60,000	[6]		
Unrealized loss on short-term marketable equity securities	13,000	[2]		
Total future tax losses which can be carried back to 1990	$73,000			
[i] Deferred tax benefit of loss carryback ($73,000 × 30%)			21,900	
Adjusted income tax expense			$156,900	
[ii] Income tax expense, as reported			$192,000	
Adjusted actual income tax expense			178,800	
			$ 13,200	
[iii] Income tax expense, as reported			$192,000	
Adjusted income tax expense			156,900	
			$ 35,100	

Explanations of Amounts

[a] Gain on sale of marketable equity securities	
Selling price	$130,000
Cost	100,000
Gain	$ 30,000
[b] Allowance to reduce marketable equity securities to market value	
Marketable equity securities, at cost	
Balance, 2/2/90 as reported	$125,000
Adjustment for recording error	30,000
Adjusted balance, 12/31/90	155,000
Market valuation, 12/31/90	142,000
Allowance required, 12/31/90	$ 13,000
[c] Prior year adjustment for pollution control devices	
Cost of installation, 12/29/89	$ 48,000
Deduct income tax effect ($48,000 × 30%)	14,400
Credit adjustment to retained earnings, 1/1/90	$ 33,600
[d] Depreciation for 1990 on pollution control devices	
Cost of the installation on 12/29/89	$ 48,000
Depreciation for 1990 ($48,000 ÷ 6 years)	$ 8,000

1N90
Answer 4 (10 points)

Zues Manufacturing Corp.
BALANCE SHEET
December 31, 1989

Assets

	Current Assets			
[1]*	Cash		$ 109,000	
[2]	Accounts receivable (net)		317,700	
	Inventories		560,000	
	Total current assets			$ 986,700
[3]	Long-term investment, at cost		51,300	
	Less allowance for excess of cost over market		4,300	47,000
	Property, plant, and equipment, at cost			
[4]	Land		200,000	
	Building	$1,750,000		
	Machinery and equipment	1,964,000		
	Total	3,714,000		
	Less accumulated depreciation	420,000	3,294,000	
	Total property, plant, and equipment			3,494,000
	Intangible asset			
	Goodwill			37,000
	Other assets			
[1]	Cash restricted for building purposes		100,000	
[2]	Officer's note receivable		30,000	
[4]	Land held for future building site		250,000	380,000
	Total assets			$4,944,700

Liabilities and Stockholders' Equity

	Current Liabilities			
[5]	Accounts payable		$ 119,800	
[6&7]	Current installments of long-term debt		200,000	
	Lawsuit liability		80,000	
[8]	Income taxes payable		21,200	
	Deferred tax liability		5,000	
	Total current liabilities			$ 426,000
	Long-term debt			
[6]	Mortgage payable		800,000	
[7]	Note payable		400,000	
	Deferred tax liability		23,000	
	Total long-term debt			1,223,000
	Stockholders' equity			
[9]	Common stock, authorized 100,000 shares of $50 par value; issued 40,000 shares; outstanding 39,800 shares		2,000,000	
[9]	Additional paid-in capital		231,000	
	Total paid-in capital		2,231,000	
	Retained earnings		1,075,400	
	Total		3,306,400	
[3]	Less: Cost of treasury stock	$6,400		
	Unrealized loss on long-term investment	4,300	10,700	
	Total stockholders' equity			3,295,700
	Total liabilities and stockholders' equity			$4,944,700

1N90
Answer 4 (cont.)

Explanations of Amounts

[1]	Cash, per unaudited balance sheet	$225,000
	Less: Unrecorded checks in payment of accounts payable	(14,000)
	NSF check not recorded	(2,000)
	Cash restricted for building purposes (reported in other assets)	(100,000)
	Corrected balance	$109,000
[2]	Accounts receivable (net), per unaudited balance sheet	$345,700
	Add charge-back for NSF check (see [1])	2,000
	Less officer's note receivable (reported in other assets)	(30,000)
	Corrected balance	$317,700
[3]	Investments, per unaudited balance sheet	$ 57,700
	Less: Long-term investment (reported separately)	(51,300)
	Treasury stock (reported in stockholders' equity)	(6,400)
	Corrected balance	$ 0
[4]	Land, per unaudited balance sheet	$450,000
	Less land acquired for future building site (reported in other assets)	(250,000)
	Corrected balance	$200,000
[5]	Accounts payable, per unaudited balance sheet	$133,800
	Less unrecorded payments (see [1])	(14,000)
	Corrected balance	$119,800
[6]	Mortgage payable, per unaudited balance sheet	$900,000
	Less current portion ($50,000 × 2)	(100,000)
	Refinanced as long-term mortgage payable	$800,000
[7]	Note payable, per unaudited balance sheet	$500,000
	Less current portion	(100,000)
	Long-term note payable	$400,000
[8]	Income taxes payable, per unaudited balance sheet	$61,200
	Less prepaid income taxes	(40,000)
	Corrected balance	$21,200
[9]	Common stock, per unaudited balance sheet	$2,231,000
	Less additional paid-in capital in excess of par value	(231,000)
	Corrected balance	$2,000,000

B. Income Statement

1M89
Answer 4 (10 points)

a.

Pitt Corp.
INCOME STATEMENT
For the Year Ended December 31, 1988

Net sales			$6,250,000
Cost of sales			3,750,000
Gross profit			2,500,000
Selling and administrative expenses			1,212,500
Operating income			1,287,500
Other expenses			
Interest expense			122,500
Income before unusual or infrequent items and income tax			1,165,000
Unusual or infrequent items			
Loss on disposition of plant assets	$(225,000)		
Gain on sale of long-term investments	130,000		(95,000)
Income before income tax and extraordinary item			1,070,000
Income tax			
Current	342,000	[1]	
Deferred	27,000	[2]	369,000
Income before extraordinary item			701,000
Extraordinary item — loss from earthquake (net of applicable income tax benefit of $142,500)			332,500 [3]
Net income			$ 368,500
Earnings per share			
Income before extraordinary item			$2.98 [4]
Extraordinary loss			(1.41) *
Net income			$1.57 [5]

*Optional

1M89
Answer 4 (cont.)

b.

Pitt Corp.
RECONCILIATION OF NET INCOME TO TAXABLE INCOME PER TAX RETURN
For the Year Ended December 31, 1988

Net income	
Add: Income tax on continuing operations	$368,500
Officers' life insurance expense	369,000
	70,000
	807,500
Deduct: Income tax benefit — extraordinary loss	142,500
Taxable income per tax return	$665,000

Explanation of amounts

[1] Total income tax excluding extraordinary item for 1988

Income before income tax and extraordinary item	$1,070,000
Officers' life insurance expense	70,000
Income subject to tax	1,140,000
Income tax rate	× 30%
Income tax excluding extraordinary item	$ 342,000

[2] Deferred income tax for 1988

Excess of book basis over tax basis in depreciable assets (Expected to reverse equally over next 5 years)	$90,000
Deferred income tax liability, 12/31/88 ($90,000 × 30%)	$27,000
Less beginning balance, 1/1/88	-0-
Net change in deferred tax liability for 1988	$27,000

[3] Extraordinary item — Loss from earthquake damage (net of income tax) for 1988

Loss from earthquake damage	$475,000
Income tax benefit (30% × $475,000)	142,500
Net of income tax effect	$332,500

[4] Earnings per share of income before extraordinary item for 1988

Income before extraordinary item	$701,000
Weighted average number of shares outstanding for 1988 [200,000 + 20,000 + 15,000 (½ × 30,000)]	235,000
Earnings per share ($701,000 ÷ 235,000)	$2.98

[5] Earnings per share on net income for 1988

Net income	$368,500
Weighted average number of shares	235,000
Earnings per share ($368,500 ÷ 235,000)	$1.57

2M88
Answer 4 (10 points)

Arlon Corporation
INCOME STATEMENT
For the Year Ended December 31, 1987

Sales		$500,000
Cost of sales		310,000
Gross margin		190,000
Administrative expenses		103,000
Operating income		87,000
Other income and expense		
Life insurance policy proceeds	$10,000	
Interest expense	(10,500)	(500)
Income from continuing operations before income tax		86,500
Income tax		
Current	$14,410	
Deferred	2,420	16,830
Income from continuing operations		69,670
Discontinued operations		
Income from discontinued Mem Division, less applicable income tax of $7,260	$25,740	
Loss on disposal of Mem Division, less applicable income tax saving of $2,750	(9,750)	15,990
Income before extraordinary item		85,660
Extraordinary item — gain on acquisition of bonds payable, less applicable income tax of $2,860		10,140
Net income		$ 95,800
Earnings per share		
From continuing operations		$.070
From discontinued operations		.016
Total before extraordinary item		.086
From extraordinary item		.010
Net income		$.096

2M88
Answer 4 (cont.)

COMPUTATION OF CURRENT AND DEFERRED INCOME TAXES

Income from continuing operations before income tax				$86,500
Less permanent difference — proceeds of life insurance policy				10,000
Balance subject to tax				76,500
Income tax rate				× 22%
Income tax on continuing operations				$16,830
Current				
Income per income tax return			$99,000	
Less intraperiod tax allocations				
Discontinued operations				
Income before income tax	$33,000			
Loss on disposal	(12,500)	$20,500		
Extraordinary item				
Gain on acquisition of bonds payable		13,000	33,500	
Taxable income on continuing operations			65,500	
Income tax rate			× 22%	
Income tax — current				$14,410
Deferred				
Depreciation per income tax return		$46,000		
Depreciation per financial statements		30,000		
Excess of depreciation per income tax return over depreciation per financial statements		16,000		
Rental revenue received in advance		(5,000)		
Net timing differences			11,000	
Income tax rate			× 22%	
Income tax — deferred				2,420
Income tax on continuing operations				$16,830

COMPUTATION OF INCOME FROM DISCONTINUED OPERATIONS
For the Six Months Ended June 30, 1987
(Date of Discontinuance)

Sales	$100,000
Cost of sales	45,000
Gross margin	55,000
Administrative expenses	15,000
Operating income	40,000
Interest expense	7,000
Income before income tax	33,000
Income tax (at 22%)	7,260
Net income	$ 25,740

C. Statement of Cash Flows

1N90
Answer 5 (10 points)

a.

Linden Consulting Associates
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 1989
Increase (Decrease) in Cash

Cash flows from operating activities:		
Cash received from customers	$ 2,586,000 [1]	
Cash paid to suppliers and employees	(1,830,000) [2]	
Dividends received from affiliate	96,000	
Net cash provided by operating activities		$ 852,000
Cash flows from investing activities:		
Purchased property and equipment		(170,000)
Cash flows from financing activities:		
Principal payment of mortgage payable	(20,000)	
Proceeds for admission of new partner	340,000	
Drawings against partners' capital accounts	(630,000)	
Net cash used in financing activities		(310,000)
Net increase in cash		372,000
Cash at beginning of year		280,000
Cash at end of year		$ 652,000

Explanation of amounts:

[1]	Fee revenue		$2,664,000
	Less ending accounts receivable balance		(446,000)
	Add beginning accounts receivable balance		368,000
			$2,586,000
[2]	Operating expenses		$1,940,000
	Less: Depreciation	$ 60,000	
	Ending accounts payable balance	320,000	(380,000)
	Add beginning accounts payable balance		270,000
			$1,830,000

1N90
Answer 5 (cont.)

b.

Reconciliation of net income to net cash provided by operating activities:

Net income			$900,000
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	$ 64,000		
Undistributed earnings of affiliate	(84,000)	[1]	
Change in assets and liabilities:			
Increase in accounts receivable	(78,000)		
Increase in accounts payable and accrued expenses	50,000		
Total adjustments			(48,000)
Net cash provided by operating activities			$852,000

[1] Linden's share of Zach, Inc.'s:

Reported net income for 1989 (25% × $720,000)	$180,000
Cash dividends paid for 1989 (25% of $384,000)	96,000
Undistributed earnings for 1989	$ 84,000

c.

Linden Consulting Associates
ANALYSIS OF CHANGES IN PARTNERS' CAPITAL ACCOUNTS
For the Year Ended December 31, 1989

	Total	*Garr*	*Pat*	*Scott*
Balance, December 31, 1988	$1,700,000	$1,020,000	$680,000	$ —
Capital investment	340,000	—	—	340,000
Allocation of net income	900,000	450,000	270,000	180,000
Balance before drawings	2,940,000	1,470,000	950,000	520,000
Drawings	630,000	280,000	200,000	150,000
Balance, December 31, 1989	$2,310,000	$1,190,000	$750,000	$370,000

1N89
Answer 5 (10 points)

Kern, Inc.
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 1988
Increase (Decrease) in Cash

Cash flows from operating activities:			
Net income	$305,000		
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	82,000	[1]	
Amortization of patent	9,000		
Loss on sale of equipment	10,000		
Equity in income of Word Corp.	(30,000)	[2]	
Gain on sale of marketable equity securities	(19,000)		
Decrease in allowance to reduce marketable equity securities to market	(15,000)		
Increase in accounts receivable	(35,000)		
Decrease in inventories	80,000		
Decrease in accounts payable and accrued liabilities	(115,000)		
Net cash provided by operating activities			$272,000
Cash flows from investing activities:			
Sale of marketable equity securities	$119,000		
Sale of equipment	18,000		
Purchase of equipment	(120,000)		
Net cash provided by investing activities			17,000
Cash flows from financing activities:			
Issuance of common stock	$260,000	[3]	
Cash dividend paid	(85,000)		
Payment on note payable	(300,000)		
Net cash used in financing activities			(125,000)
Net increase in cash			164,000
Cash at beginning of year			307,000
Cash at end of year			$471,000

Explanations of Amounts:

[1] Depreciation	
Net increase in accumulated depreciation for year ended 12/31/88	$ 65,000
Accumulated depreciation on equipment sold	17,000
Depreciation for 1988	$ 82,000
[2] Equity in income of Word Corp.	
Reported net income for 1988	$150,000
Kern's ownership	× 20%
Equity in income of Word Corp. for 1988	$ 30,000
[3] Issuance of common stock	
4/15/88, issued 20,000 shares for cash at $13 per share	$260,000

D. Statement of Owners' Equity

1N91
Answer 4 (10 points)

Candidate's No. ____________
State ____________
Question No. 4 **Page** ____________

a.

Dey Toys
WORKSHEET TO CONVERT
TRIAL BALANCE TO ACCRUAL BASIS
December 31, 1990

	Cash Basis		*Adjustments*		*Accrual Basis*	
Account Title	*Dr.*	*Cr.*	*Dr.*	*Cr.*	*Dr.*	*Cr.*
Cash	8,200				8,200	
Accounts receivable	9,000		(1) 8,800		17,800	
Inventory	40,000		(3) 6,000		46,000	
Machinery & equipment	70,000				70,000	
Leasehold improvements	28,800				28,800	
Accumulated depreciation & amort.		18,000		(6) 11,500		29,500
Accounts payable		9,600		(7) 9,000		18,600
Payroll taxes withheld		1,700				1,700
Dey, drawings	—		(10) 55,800		55,800	
Dey, capital		67,300	(8) 1,600	(5) 11,250		78,030
				(4) 1,080		
Allowance for uncollectible accounts				(2) 2,100		2,100
Prepaid insurance			(4) 1,200		1,200	
Prepaid rent			(5) 12,600		12,600	
Accrued expenses				(8) 2,520		2,520
Estimated liability from lawsuit				(9) 35,000		35,000
Sales		374,000		(1) 8,800		382,800
Purchases	165,400		(7) 9,000		174,400	
Salaries	107,000		(8) 270	(10) 48,000	59,270	
Payroll taxes	5,800		(8) 300		6,100	
Insurance	4,800			(4) 120	4,680	
Dey's living expenses	7,800			(10) 7,800		
Rent	16,800			(5) 1,350	15,450	
Utilities	7,000		(8) 350		7,350	
Income summary — inventory			(3) 40,000	(3) 46,000		6,000
Depreciation & amortization			(6) 11,500		11,500	
Uncollectible accounts			(2) 2,100		2,100	
Estimated loss from lawsuit			(9) 35,000		35,000	
	470,600	470,600	184,520	184,520	556,250	556,250

Explanations of Adjustments

[1] To convert 1990 sales to accrual basis.

Accounts receivable balances:	
December 31, 1990	$17,800
December 31, 1989	9,000
Increase in sales	$ 8,800

[2] To record provision for uncollectible accounts.

[3] To record increase in inventory from 12/31/89 to 12/31/90.

Inventory balances:	
December 31, 1990	$46,000
December 31, 1989	40,000
Increase in inventory	$ 6,000

[4] To adjust prepaid insurance.

Prepaid balances:	
December 31, 1990 ($4,800 × 3/12)	$1,200
December 31, 1989 ($4,320 × 3/12)	1,080
Decrease in insurance expense	$ 120

[5] To adjust prepaid rent.

Prepaid balances:	
December 31, 1990 ($16,800 × 9/12)	$12,600
December 31, 1989 ($15,000 × 9/12)	11,250
Decrease in rent expense	$ 1,350

[6] To record 1990 depreciation and amortization expense.

Cost of leasehold improvement	$28,800
Estimated life limited to lease term	8 years
Amortization ($28,800 × 1/8 × 1/4)	900
Depreciation expense on machinery and equipment	10,600
	$11,500

[7] To convert 1990 purchases to accrual basis.

Accounts payable balances:	
December 31, 1990	$18,600
December 31, 1989	9,600
Increase in purchases	$ 9,000

[8] To convert expenses to accrual basis.

	Balances December 31, 1990	*Balances December 31, 1989*	*Increase in expenses*
Utilities	$ 850	$ 500	$350
Salaries	770	500	270
Payroll taxes	900	600	300
	$2,520	$1,600	$920

[9] To record lawsuit liability at 12/31/90.

Attorney's estimate of probable loss	$135,000
Amount covered by insurance	100,000
Dey's estimated liability	$ 35,000

[10] To record Dey's drawings for 1990.

Salary	$48,000
Living expenses	7,800
	$55,800

b.

Dey Toys
STATEMENT OF CHANGES IN DEY, CAPITAL
For the Year Ended December 31, 1990

Dey, capital, December 31, 1989	$ 78,030 (1)
Add net income for the year	72,950 (2)
	150,980
Deduct drawings for the year	55,800
Dey, capital, December 31, 1990	$ 95,180

Explanation of Amounts

[1] Dey, capital, 12/31/89 after adjustment to accrual basis per worksheet.

[2] Computation of net income on accrual basis for the year ended 12/31/90. (Per worksheet)

Sales		$382,800
Purchases	$174,400	
Income summary-inventory	(6,000)	
Salaries	59,270	
Payroll taxes	6,100	
Insurance	4,680	
Rent	15,450	
Utilities	7,350	
Depreciation	11,500	
Uncollectible accounts	2,100	
Provision for lawsuit	35,000	309,850
Net income		$ 72,950

1M90
Answer 5 (10 points)

a.

Mart, Inc.
STATEMENT OF RETAINED EARNINGS
For the Year Ended December 31, 1989

Balance, December 31, 1988			
As originally reported			$3,250,000
Less prior period adjustment from error overstating inventories at December 31, 1988	$ 200,000		
Less income tax effect	60,000		140,000
As restated			3,110,000
Net income			2,250,000
			5,360,000
Deduct cash dividends on:			
Preferred stock	450,000	[1]	
Common stock	2,480,000	[2]	2,930,000
Balance, December 31, 1989			$2,430,000

b.

Mart, Inc.
STOCKHOLDERS' EQUITY
December 31, 1989

Preferred stock, $50 par value, 9% cumulative, convertible; 250,000 shares authorized; 100,000 shares issued and outstanding			$ 5,000,000	
Common stock, $5 par value; 6,000,000 authorized; 2,500,000 shares issued, of which 10,000 shares are held in treasury			12,500,000	[3]
Additional paid-in capital			11,450,000	[4]
Retained earnings			2,430,000	
			31,380,000	
Less contra accounts:				
Common stock in treasury, 10,000 shares at cost	$160,000	[5]		
Excess of cost over fair market value of a long-term investment in a marketable equity security	50,000	[6]	210,000	
			$31,170,000	

c.

Mart, Inc.
COMPUTATION OF BOOK VALUE PER SHARE OF COMMON STOCK
December 31, 1989

Total stockholders' equity	$31,170,000
Deduct allocation to preferred stock, at liquidation value [100,000 shares × $55]	5,500,000
Allocation to common stock [Shares outstanding 2,490,000 (2,500,000 − 10,000)]	$25,670,000
[$25,670,000 ÷ 2,490,000]	$ 10.31

Explanation of Amounts

[1]	Preferred stock dividend		
	Par value of all outstanding preferred stock shares		$ 5,000,000
	Dividend rate		9%
	Dividends paid on preferred stock		$450,000
[2]	Common stock dividend		
	Number of common stock shares outstanding, 12/31/88		2,000,000
	Number of common stock shares issued, 4/30/89		500,000
	Total common stock shares issued		2,500,000
	Less: Treasury stock shares acquired 2/1/89		20,000
	Shares outstanding, 7/1/89		2,480,000
	Dividends paid (2,480,000 × $1)		$2,480,000
[3]	Common stock shares issued (see [2] above)		2,500,000
	Par value per share		$5
	Common stock at par value ($5 × 2,500,000)		$12,500,000
[4]	Additional paid-in capital		
	Balance, December 31, 1988		$7,500,000
	From issuance of stock:		
	100,000 shares of preferred stock on 1/5/89		
	[100,000 × $4 ($54 − $50)]		400,000
	500,000 shares of common stock on 4/30/89		
	[500,000 × $7 ($12 − $5)]		3,500,000
	From sale of 10,000 shares of treasury stock on 11/6/89		
	[10,000 × $5 ($21 − $16)]		50,000
	Balance, December 31, 1989		$11,450,000
		Shares	*Amount of cost*
[5]	Common stock in treasury		
	Stock reacquired, 2/1/89	20,000	$320,000
	Stock sold, 11/6/89	10,000	160,000
		10,000	$160,000
[6]	Excess of cost of long-term marketable equity security		
	Cost of marketable equity security		$200,000
	Fair market value of marketable equity security, 12/31/89		
	[$15 × 10,000 shares]		150,000
			$ 50,000

E. Consolidated Financial Statements or Worksheets

1N91
Answer 5 (10 points)

a.

Pine Corp.
JOURNAL ENTRIES
March 31, 1990

Account	*Dr.*		*Cr.*	
Investment in Strand, Inc.	5,400,000	[1]		
Common stock			2,000,000	
Additional paid-in capital			970,000	[2]
Retained earnings of subsidiary			2,430,000	
To record issuance of 200,000 shares of common stock for all the outstanding common stock of Strand, Inc., in a business combination accounted for by the pooling-of-interests method				
Expenses of business combination	720,000			
Cash			720,000	
To record payment of the expenses relating to the business combination with Strand, Inc.				

Explanations of Amounts

[1] Investment in Strand, Inc.		
Carrying amount of Strand's stockholders' equity, March 31, 1990		
Capital stock		$2,500,000
Additional paid-in capital		470,000
Retained earnings		2,430,000
Total		$5,400,000
[2] Additional paid-in capital		
Strand, Inc. additional paid-in capital, March 31, 1990		$ 470,000
Par value of Strand, Inc. common stock acquired	$2,500,000	
Par value of Pine Corp. common stock issued (200,000 shares × $10)	2,000,000	
Excess added to additional paid-in capital		500,000
Total		$ 970,000

b.

Pine Corp.
INVESTMENT IN STRAND, INC. — AT EQUITY
December 31, 1990

Balance at date of acquisition, 3/31/90			$5,400,000
Net income of Strand, Inc. for period 4/1 through 12/31/90	$1,060,000	[3]	
Less: Elimination of intercompany profit in Strand's inventory	200,000		860,000
Balance, 12/31/90			$6,260,000

Explanation of Amounts

[3] Net income of Strand, Inc. for period 4/1 through 12/31/90

Retained earnings, 12/31/89		$2,290,000
Net income for 1990	$1,450,000	
Less: Dividend paid, 3/10/90	(250,000)	
Net increase in 1990 retained earnings		1,200,000
Retained earnings, 12/31/90		3,490,000
Retained earnings, 3/31/90		(2,430,000)
Net income for period 4/1 through 12/31/90		$1,060,000

c.

Pine Corp. and Subsidiary
CONSOLIDATED STATEMENT OF CHANGES IN RETAINED EARNINGS
For the Year Ended December 31, 1990

Balance, December 31, 1989:		
As originally reported	$ 6,820,000	
Adjustment for pooling of interests with Strand, Inc.	2,290,000	
As restated	9,110,000	
Net income	3,490,000	[4]
	12,600,000	
Dividends paid:		
By Strand, Inc., before combination	(250,000)	
By Pine Corp., after combination	(1,500,000)	
	(1,750,000)	
Balance, December 31, 1990	$10,850,000	

Explanation of Amounts

[4] Consolidated net income for 1990

Pine Corp.'s income before considering equity in Strand's net income	$2,240,000
Strand, Inc.'s separate net income	1,450,000
	3,690,000
Elimination of intercompany profit in Strand's inventory (1/4 × $800,000)	(200,000)
Consolidated net income for 1990	$3,490,000

1M90
Answer 4 (10 points)

Cain Corp. and Subsidiary
CONSOLIDATING STATEMENT WORKSHEET
December 31, 1989

Income Statement	*Cain Corp. Dr. (Cr.)*	*Frey, Inc. Dr. (Cr.)*	*Adjustments & Eliminations* Dr.	*Adjustments & Eliminations* Cr.	*Adjusted Balance*
Net sales	(3,800,000)	(1,500,000)	[6] 180,000		(5,120,000)
Dividends from Frey	(40,000)		[3] 40,000		
Gain on sale of warehouse	(30,000)		[4] 30,000		
Cost of goods sold	2,360,000	870,000		[6] 162,000	3,068,000
Operating expenses (including depreciation)	1,100,000	440,000	[2] 12,000	[5] 2,000	1,550,000
Net income	(410,000)	(190,000)	[a] 262,000	[a] 164,000	(502,000)
Retained Earnings Statement					
Balance, 1/1/89	(440,000)	(156,000)	[1] 156,000		(440,000)
Net income	(410,000)	(190,000)	[a] 262,000	[a] 164,000	(502,000)
Dividends paid		40,000		[3] 40,000	
Balance, 12/31/89	(850,000)	(306,000)	[b] 418,000	[b] 204,000	(942,000)
Balance Sheet					
Assets: Cash	570,000	150,000			720,000
Accounts receivable (net)	860,000	350,000		[7] 86,000	1,124,000
Inventories	1,060,000	410,000		[6] 18,000	1,452,000
Land, plant and equipment	1,320,000	680,000	[1] 54,000	[4] 30,000	2,024,000
Accumulated depreciation	(370,000)	(210,000)	[5] 2,000	[2] 9,000	(587,000)
Investment in Frey (at cost)	750,000			[1] 750,000	
Goodwill			[1] 60,000	[2] 3,000	57,000
Total Assets	4,190,000	1,380,000			4,790,000
Liabilities & Stockholders' Equity: Accounts payable & accrued expenses	(1,340,000)	(594,000)	[7] 86,000		(1,848,000)
Common stock ($10 par)	(1,700,000)	(400,000)	[1] 400,000		(1,700,000)
Additional paid-in capital	(300,000)	(80,000)	[1] 80,000		(300,000)
Retained earnings	(850,000)	(306,000)	[b] 418,000	[b] 204,000	(942,000)
Total Liabilities & Stockholders' Equity	(4,190,000)	(1,380,000)	1,100,000	1,100,000	(4,790,000)

Explanations of Adjustments & Eliminations

[1] To eliminate the reciprocal elements in investment, goodwill, equity and property accounts. Cain's investment is carried at cost at December 31, 1989.

[2] To record amortization of the fair value in excess of book value of Frey's machinery at date of acquisition ($54,000 ÷ 6) and amortization of goodwill ($60,000 ÷ 20) for the year ended December 31, 1989.

[3] To eliminate Cain's dividend revenue from Frey.

[4] To eliminate intercompany profit on the sale of the warehouse by Cain to Frey.

[5] To eliminate the excess depreciation on the warehouse building sold by Cain to Frey [½ × $4,000 ($86,000 − $66,000 × 1/5)].

[6] To eliminate intercompany sales from Cain to Frey and the intercompany profit in Cain's ending inventory as follows:

	Total	*On hand*
Sales	$180,000	$36,000
Gross profit	90,000	18,000

[7] To eliminate Cain's intercompany balance to Frey for the merchandise it purchased.

1N88
Answer 5 (10 points)

a.

Peel, Inc. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
December 31, 1987

	Peel, Inc.	Stagg, Inc.	Adjustments & Eliminations Debit	Adjustments & Eliminations Credit	Consolidated Balance
Assets:					
Cash	$ 925,000	$ 300,000			$1,225,000
Accounts and other receivables	2,140,000	835,000		[3] $ 8,000	2,247,000
				[4] 720,000	
Inventories	2,310,000	1,045,000		[5] 90,000	3,265,000
Land	600,000	330,000			930,000
Depreciable assets, net	4,525,000	1,980,000			6,505,000
Investment in Stagg, Inc.	2,430,000			[1] 2,430,000	
Long-term investments and other assets	865,000	385,000		[2] 320,000	930,000
	$13,795,000	$4,875,000			$15,102,000
Liabilities and stockholders' equity:					
Accounts payable and other current liabilities	$2,465,000	$1,145,000	[3] $ 8,000		$ 2,882,000
			[4] 720,000		
Long-term debt	1,900,000	1,300,000	[2] 320,000		2,880,000
Common stock, $25 par value	3,200,000	1,000,000	[1] 1,000,000		3,200,000
Additional paid-in capital	1,850,000	190,000	[1] 190,000		1,850,000
Retained earnings	4,380,000	1,240,000	[1] 1,240,000		4,290,000
			[5] 90,000		
	$13,795,000	$4,875,000	$3,568,000	$3,568,000	$15,102,000

b. *Peel, Inc. and Subsidiary*
CONSOLIDATED STATEMENT OF RETAINED EARNINGS
For the Year Ended December 31, 1987

Balance, December 31, 1986:		
As originally reported	$2,506,000	
Adjustment for pooling of interests with Stagg, Inc.	820,000	
As restated	3,326,000	
Net income	1,380,000	[6]
	4,706,000	
Deduct cash dividends paid:		
By Stagg, Inc., prior to combination	160,000	[7]
By Peel, Inc., after the combination	256,000	
	416,000	
Balance, December 31, 1987	$4,290,000	

Explanations of Worksheet Entries & Other Amounts

[1] To eliminate the reciprocal elements in investment and equity accounts.

[2] To eliminate Peel's investment in Stagg's bonds.

[3] To eliminate Peel's intercompany accrued interest receivable on its investment in Stagg's bonds for the period 10/1 – 12/31/87. ($320,000 × 10% × 1/4 = $8,000)

[4] To eliminate Peel's intercompany balance for merchandise owed by Stagg.

[5] To eliminate intercompany profit in ending inventory of Stagg. ($180,000 × 1/2 = $90,000)

[6] Consolidated net income for 1987

Peel, Inc.	$ 890,000	
Stagg, Inc.	580,000	
	$1,470,000	
Deduct intercompany profit in inventory	90,000	[5]
	$1,380,000	

[7] Dividend paid 6/15/87

[40,000 shares × $4]	$ 160,000

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

1M89
Answer 5 (10 points)

a.

Poe Corp.
SCHEDULE OF CURRENT MARKETABLE EQUITY SECURITIES
December 31, 1988

	Number of shares	*Cost*	*Market price per share*	*Market value*	*Unrealized gain or (loss)*
Axe — preferred	500	$ 20,000	$56	$ 28,000	$ 8,000
Axe — common	1,500	20,000	20	30,000	10,000
Purl — common	3,500	35,000	11	38,500	3,500
Day — common	1,700	42,500	22	37,400	(5,100)
		$117,500		$133,900	$16,400
Valuation allowance [1]		-0-			
Carried at cost		$117,500			

b.

Poe Corp.
SCHEDULE OF NONCURRENT MARKETABLE EQUITY SECURITIES
December 31, 1988

Scott Corp. — 100,000 shares of common stock:

Cost:				$1,700,000
Acquisition price				
Increase in equity during 1988:				
Equity in Scott's income			$360,000	
Less:				
Amortization of excess of cost over underlying equity	$ 7,500	[2]		
Dividends received	200,000		207,500	
Net increase in equity				152,500
Carrying amount of Poe Corp.'s investment in Scott				$1,852,500

c.

Poe Corp.
SCHEDULE OF INVESTMENT INCOME
For the Year Ended December 31, 1988

Dividends:			
Axe Corp. — preferred (1,000 shares × $2.40 per share)		$ 2,400	
Purl, Inc. — common (3,500 shares × $1.00 per share)		3,500	
Total dividend revenue			$ 5,900
Gains on marketable equity securities:			
Unrealized gain on current marketable equity securities		7,000 [1]	
Realized gain/(loss) on sale of securities:			
Purl, Inc. — common ($13 − $10 = $3 × 2,500 shares)	$ 7,500		
Day Co. — common ($55,000/2,000 shares × 110%), or cost per share of $25 − $21 selling price per share = $4 loss per share × 500 shares sold	(2,000)		
Net realized gain on sale of securities		5,500	
Net gains on current marketable equity securities			12,500
Equity in income of Scott Corp.:			
Poe's 30% interest in Scott's net income of $1,200,000		360,000	
Amortization of excess of cost over underlying equity		(7,500) [2]	
Equity in income of Scott Corp.			352,500
			$370,900

Explanation of Amounts:

[1] The valuation allowance of $7,000 at December 31, 1987, for current marketable equity securities should be eliminated by a debit to valuation allowance — current, and a credit to unrealized gain on current marketable equity securities. The $7,000 unrealized gain should be included in Poe's income statement for the year ended December 31, 1988.

[2]

Poe's acquisition price for its 30% interest	$1,700,000
Poe's interest in the underlying equity	1,400,000
Excess of cost over underlying equity	$ 300,000
Amortization based on 40 years	$ 7,500

B. Receivables and Accruals

1M92
Answer 4(b) (5 points)

a.

Sigma Co.
SCHEDULE OF CALCULATION OF ALLOWANCE FOR UNCOLLECTIBLE ACCOUNTS
December 31, 1991

0 to 30 days	$300,000 × 1%	$ 3,000
31 to 90 days	80,000 × 5%	4,000
91 to 180 days	60,000 × 20%	12,000
Over 180 days	25,000 × 80%	20,000
Accounts receivable	$465,000	
Allowance for uncollectible accounts		$39,000

b. Computation of 1991 provision:

Balance December 31, 1990	$28,000
Writeoffs during 1991	(27,000)
Recoveries during 1991	7,000
Balance before 1991 provision	8,000
Required allowance at December 31, 1991	39,000
1991 provision	$31,000

1M88
Answer 5 (10 points)

a.

Rowe Corp.
SCHEDULE OF CHANGES IN NOTE FROM SALE OF PATENT
1987

Face amount, 5/1/87 (due 5/1/90)	$500,000
Deduct imputed interest [$500,000 − ($500,000 × 0.675)]	162,500
Balance, 5/1/87	337,500
Add interest earned to 12/31/87 ($337,500 × 14% × $^8/_{12}$)	31,500
Balance, 12/31/87, noncurrent	$369,000

Rowe Corp.
SCHEDULE OF CHANGES IN INSTALLMENT CONTRACT RECEIVABLE
1987

Balance, 12/31/86	$720,000
Deduct payment, 3/31/87	180,000
Balance, 3/31/87 and 12/31/87	540,000
Deduct installment due 3/31/88	180,000
Balance, 12/31/87, noncurrent	$360,000

Rowe Corp.
SCHEDULE OF CHANGES IN INVESTMENT IN BLACK CORP., AT EQUITY
1987

	Underlying equity		*Goodwill*		*Total at equity*
25% interest, 7/1/87	$1,600,000	[1]	$280,000		$1,880,000
Period 7/1/87 to 12/31/87					
Equity in earnings	176,000	[2]			176,000
Dividend, 11/30/87	(150,000)	[3]			(150,000)
Amortization of goodwill			(3,500)	[4]	(3,500)
Balance, 12/31/87	$1,626,000		$276,500		$1,902,500

Rowe Corp.
SCHEDULE OF CHANGES IN PATENT
1987

Cost, net of accumulated amortization, 12/31/86	$ 245,000
Deduct amortization, 1/1/87 to 5/1/87 ($315,000 ÷ 15 × 4/12)	(7,000)
	238,000
Cost of patent sold, 5/1/87	(238,000)
Balance, 12/31/87	$ 0

Rowe Corp.
SCHEDULE OF CHANGES IN TRADEMARK
1987

Cost, 1/2/87	$250,000
Deduct amortization for 1987 ($250,000 ÷ 40)	6,250
Balance, net of accumulated amortization, 12/31/87	$243,750

Explanations of Amounts

Underlying equity (25% × $6,400,000)	$1,600,000	[1]
Equity in earnings (25% × $704,000)	$ 176,000	[2]
Dividend, 11/30/87 ($2 × 75,000 shares)	$ 150,000	[3]
Amortization of goodwill ($280,000 ÷ 40 × ½)	$ 3,500	[4]

1M88
Answer 5 (cont.)

b.

Rowe Corp.
SCHEDULE OF REVENUES, GAINS, AND EXPENSES
RELATING TO OTHER NONCURRENT ASSETS
For the Year Ended December 31, 1987

Gain recognized on sale of patent	$ 99,500	[5]
Interest revenue		
Noninterest-bearing note	$ 31,500	[Part a]
Installment contract	76,050	[6]
Total	$107,550	
Equity in earnings of Black Corp.	$172,500	[7]
Amortization expense — intangibles		
Patent	$ 7,000	[Part a]
Trademark	6,250	[Part a]
Total	$ 13,250	

Explanations of Amounts

[5] Gain recognized on sale of patent

Selling price (net of imputed interest)	$337,500	[Part a]
Carrying amount of patent at date of sale	238,000	[Part a]
Gain recognized	$ 99,500	

[6] Interest revenue — installment contract

Interest received 3/31/87 ($720,000 × 13%)	$93,600	
Interest 1/1/87 to 3/31/87	× 1/4	$ 23,400
Interest accrued 4/1/87 to 12/31/87 ($540,000 × 13% × 9/12)		52,650
Interest, year ended 12/31/87		$ 76,050

[7] Equity in earnings of Black Corp.

Equity in Black's net income for 1987	$176,000	[2]
Deduct amortization of goodwill	3,500	[4]
Equity in earnings of Black Corp.	$172,500	

D. Property, Plant, and Equipment Owned or Leased

1N89
Answer 4 (10 points)

a.

Schedule 1

Nan Co.
ANALYSIS OF CHANGES IN ACCUMULATED DEPRECIATION AND AMORTIZATION
For the Year Ended December 31, 1988

	Balance 12/31/87	*Increase*	*Decrease*	*Balance 12/31/88*
Land	$ 275,000	$ —	$ —	$ 275,000
Buildings	2,800,000	1,875,000 [1]	—	4,675,000
Machinery and equipment	1,380,000	369,000 [2]	17,000	1,732,000
Automobiles and trucks	210,000	25,000	48,000	187,000
Leasehold improvements	432,000	—	—	432,000
Totals	$5,097,000	$2,269,000	$65,000	$7,301,000

Explanations of amounts:

[1] Construction cost of building

Direct costs		$1,095,000
Overhead costs		
Fixed (15,000 hours × $25)	$375,000	
Variable (15,000 hours × $27)	405,000	780,000
		$1,875,000

[2] Machinery and equipment purchased

Invoice cost	$325,000
Installation cost (concrete embedding)	18,000
Cost of gaining access to factory ($19,000 + $7,000)	26,000
Total acquisition cost	$369,000

1N89
Answer 4 (cont.)

b. 1.

Nan Co.
SCHEDULE OF DEPRECIATION AND AMORTIZATION EXPENSE
For the Year Ended December 31, 1988

Buildings		
Carrying amount, 1/1/88 ($2,800,000 − $672,900)	$2,127,100	
Building completed 1/6/88	1,875,000	
Total subject to depreciation	4,002,100	
150% declining balance [(100% ÷ 25) × 1.5]	× 6%	
Depreciation for 1988		$240,126
Machinery and equipment		
Balance, 1/1/88	$1,380,000	
Straight-line (100% ÷ 10)	× 10%	$138,000
Purchased 7/1/88	369,000	
Straight-line (10% × 6/12)	× 5%	18,450
Depreciation for 1988		$156,450
Automobiles and trucks		
Carrying amount, 1/1/88 ($210,000 − $114,326)	$ 95,674	
Deduct carrying amount, 1/1/88 on truck sold 9/30/88	30,000	
Amount subject to depreciation	65,674	
150% declining balance [(100% ÷ 5) × 1.5]	× 30%	$ 19,702
Automobile purchased 8/30/88	25,000	
150% declining balance (30% × 4/12)	× 10%	2,500
Truck sold 9/30/88 — depreciation for 1988 (1/1 to 9/30/88) ($30,000 × 30% × 9/12)		6,750
Depreciation for 1988		$ 28,952
Leasehold improvements		
Amortization for 1988 ($432,000 ÷ 12 years)		$36,000

b. 2.

Schedule 2

Nan Co.
ANALYSIS OF CHANGES IN ACCUMULATED DEPRECIATION AND AMORTIZATION
For the Year Ended December 31, 1988

	Balance 12/31/87	*Increase*	*Decrease*		*Balance 12/31/88*
Buildings	$ 672,900	$240,126	$ —		$ 913,026
Machinery and equipment	367,500	156,450	14,025	[1]	509,925
Automobiles and trucks	114,326	28,952	24,750	[2]	118,528
Leasehold improvements	108,000	36,000	—		144,000
Totals	$1,262,726	$461,528	$38,775		$1,685,479

	[1]	[2]
Cost	$17,000	$48,000
Carrying Amount	2,975	23,250*
Accumulated Depreciation	$14,025	$24,750

*($30,000 − $6,750)

c.

Nan Co.
GAIN ON DISPOSITION OF PROPERTY, PLANT, AND EQUIPMENT
For the Year Ended December 31, 1988

	Selling price	*Carrying amount*	*Gain*
Sale of truck	$23,500	$23,250	250
Machine exchanged for debt	4,000	2,975	1,025
	$27,500	$26,225	$1,275

1N88
Answer 4 (10 points)

a.

Cord Company
ANALYSIS OF CHANGES IN PLANT ASSETS
For the Year Ended December 31, 1987

	Balance 12/31/86	*Increase*		*Decrease*	*Balance 12/31/87*
Land	$ 175,000	$ 312,500	[1]	$ —	$ 487,500
Land improvements	—	192,000		—	192,000
Buildings	1,500,000	937,500	[1]	—	2,437,500
Machinery and equipment	1,125,000	385,000	[2]	17,000	1,493,000
Automobiles and trucks	172,000	12,500		24,000	160,500
Leasehold improvements	216,000	—		—	216,000
	$3,188,000	$1,839,500		$41,000	$4,986,500

Explanations of Amounts:

[1] Plant facility acquired from King 1/6/87 — allocation to Land and Building

Fair value — 25,000 shares of Cord common stock at $50 market price — $1,250,000

Allocation in proportion to appraised values at the exchange date

	Amount	*% to Total*
Land	$187,500	25
Building	562,500	75
	$750,000	100

Land	($1,250,000 × 25%)	$ 312,500
Building	($1,250,000 × 75%)	937,500
		$1,250,000

[2] Machinery and equipment purchased 7/1/87

Invoice cost	$ 325,000
Delivery cost	10,000
Installation cost	50,000
Total acquisition cost	$ 385,000

b.

Cord Company
DEPRECIATION AND AMORTIZATION EXPENSE
For the Year Ended December 31, 1987

Land improvements		
Cost	$ 192,000	
Straight-line rate (100% ÷ 12)	× 8⅓%	
Annual depreciation	16,000	
Depreciation on land improvements for 1987 (3/25 to 12/31/87)	× ¾	$ 12,000
Buildings		
Carrying amount, 1/1/87 ($1,500,000 – $328,900)	$1,171,100	
Building acquired 1/6/87	937,500	
Total amount subject to depreciation	2,108,600	
150% declining balance rate [(100% ÷ 25) × 1.5]	× 6%	
Depreciation on buildings for 1987		126,516
Machinery and equipment		
Balance, 1/1/87	$1,125,000	
Straight-line rate (100% ÷ 10)	× 10%	112,500
Purchased 7/1/87	385,000	
Depreciation for 1987 (10% × 6/12)	× 5%	19,250
Depreciation on machinery and equipment for 1987		131,750
Automobiles and trucks		
Carrying amount, 1/1/87 ($172,000 – $100,325)	$ 71,675	
Deduct carrying amount, 1/1/87 on truck sold 9/30/87 ($9,100 + $2,650)	11,750	
Amount subject to depreciation	59,925	
150% declining balance rate [(100% ÷ 5) × 1.5]	× 30%	17,978
Automobile purchased 8/30/87	12,500	
Depreciation for 1987 (30% × 4/12)	× 10%	1,250
Truck sold 9/30/87 – depreciation for 1987 (1/1 to 9/30/87)		2,650
Depreciation on automobilies and trucks for 1987		21,878
Leasehold improvements		
Carrying amount, 1/1/87 ($216,000 – $108,000)	$108,000	
Amortization period (1/1/87 to 12/31/91)	÷ 5 years	
Amortization in leasehold improvements for 1987		21,600
Total depreciation and amortization expense for 1987		$313,744

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

1M92
Answer 5 (10 points)

a.

Tempo Co.
INCOME TAX EXPENSE AND NET INCOME
For the Year Ended December 31, 1991

Income before income taxes		$430,000
Income tax expense:		
Current [30% × (430,000 – 30,000)]	$120,000	
Deferred [see computation below]	9,000	129,000
Net income		$301,000

Computation:

Deferred income tax expense		
Temporary difference — depreciation		
1992	$10,000	
1993	15,000	
1994	20,000	$45,000
Effective tax rate for years 1992 through 1994		35%
Deferred tax liability, 12/31/91		15,750
Less:		
12/31/90 deferred tax asset	9,000	
12/31/90 deferred tax liability	(15,750)	(6,750)
1991 deferred income tax expense		$ 9,000

b.

Tempo Co.
CALCULATION OF INTEREST EXPENSE
For the Year Ended December 31, 1991

Note payable — bank		
1/1/91 to 9/30/91 — $75,000 × 10% × $^9/_{12}$	$5,625	
10/1/91 to 12/31/91 — $70,000 × 10% × $^3/_{12}$	1,750	$ 7,375
Capital lease obligation		
1/1/91 to 12/31/91 — $75,260 × 10%		7,526
Bonds payable		
7/1/91 to 12/31/91 — $459,725 × 12% × $^6/_{12}$		27,584
		$42,485

c.

Tempo Co.
LONG-TERM LIABILITIES SECTION OF BALANCE SHEET
December 31, 1991

Long-term liabilities:		
Note payable — bank; 14 principal payments of $5,000 plus 10% interest due annually on September 30	$70,000	
Less current portion	5,000	$65,000
Capital lease obligation — 15 payments of $9,000 due annually on January 1	75,260	
Less current portion	1,474	73,786
11% bonds payable due June 30, 2021, less unamortized discount of $40,191		459,809
Deferred income tax liability		12,250
Total long-term liabilities		$610,845

2N88
Answer 4 (10 points)

a.

Lino Corporation
LONG-TERM LIABILITIES SECTION
OF BALANCE SHEET
December 31, 1987

10% note payable to bank, due in annual installments of $200,000, less current installment	$ 400,000	[1]
Liability under capital lease, net present value of lease payments, less current installment	160,768	[2]
10% bonds payable due July 1, 1997, less unamortized discount of $243,750	756,250	[3]
Deferred income taxes	115,000	[4]
Total long-term liabilities	$1,432,018	

2N88
Answer 4 (cont.)

b.

Lino Corporation
INTEREST EXPENSE
For the Year Ended December 31, 1987

Note payable to bank	$ 75,000	[5]
Liability under capital lease	44,800	[2]
Bonds payable	56,250	[3]
Total	$ 176,050	

Explanations of Amounts

[1] 10% Note payable to bank		
Note payable, 12/31/86		$800,000
Less installment paid 10/1/87		200,000
Balance, 12/31/87		600,000
Less current installment due 10/1/88		200,000
Long-term portion, 12/31/87		$400,000
[2] Liability under capital lease		
Liability under capital lease, 12/31/86		$280,000
Less principal portion of 12/31/87 payment		
Lease payment	$100,000	
Less imputed interest ($280,000 × 16%)	44,800	55,200
Balance, 12/31/87		224,800
Less current principal payment due 12/31/88		
Lease payment	100,000	
Less imputed interest ($224,800 × 16%)	35,968	64,032
Long-term portion, 12/31/87		$160,768
[3] Bonds payable		
Bonds payable issued 7/1/87		$750,000
Add amortization of bond discount		
Effective interest ($750,000 × 15% × $^6/_{12}$)	56,250	
Less accrued interest payable 12/31/87 ($1,000,000 × 10% × $^6/_{12}$)	50,000	6,250
Balance, 12/31/87		$756,250
[4] Deferred income taxes		
Deferred income taxes, 12/31/86		$100,000
Add timing difference — excess of tax depreciation over book depreciation of $50,000 × 30%		15,000
Balance, 12/31/87		$115,000
[5] Interest expense on note payable to bank		
1/1/87 to 9/30/87 ($800,000 × 10% × $^9/_{12}$)		$ 60,000
10/1/87 to 12/31/87 ($600,000 × 10% × $^3/_{12}$)		15,000
Interest, year ended 12/31/87		$ 75,000

1M88
Answer 4 (10 points)

a.

Fay, Inc.
LONG-TERM LIABILITIES SECTION
OF BALANCE SHEET
December 31, 1987

9% unsecured note payable to bank, due in annual principal installments of $800,000, less current portion	$ 3,200,000	[1]
11% debenture bonds payable due December 31, 1999, plus unamortized premium of $337,640	5,337,640	[2]
Total long-term liabilities	$ 8,537,640	

b.

Fay, Inc.
STOCKHOLDERS' EQUITY SECTION
OF BALANCE SHEET
December 31, 1987

Common stock, $10 par; 2,000,000 shares authorized; 840,000 shares issued; 829,500 shares outstanding			$ 8,400,000	[3]
Additional paid-in capital			2,485,000	[4]
Retained earnings			4,765,000	[5]
			15,650,000	
Less: net unrealized loss on noncurrent marketable equity securities	$ 20,000	[6]		
Treasury stock, at cost, 10,500 shares	130,000	[7]	(150,000)	
Total stockholders' equity			$15,500,000	

c.

Fay, Inc.
INTEREST EXPENSE
For the Year Ended December 31, 1987

Note payable to bank	$ 60,000	[8]
Debenture bonds payable	535,240	[9]
Total interest expense	$595,240	

Explanations of Amounts

[1] 9% note payable to bank

Note payable, 11/1/87	$4,000,000
Deduct installment due 11/1/88	800,000
Long-term portion, 12/31/87	$3,200,000

1M88
Answer 4 (cont.)

[2]	Debenture bonds payable		
	Carrying amount, 12/31/86		$5,352,400
	Deduct amortization of bond premium		
	Interest paid 12/31/87 ($5,000,000 × 11%)	$550,000	
	Less effective interest ($5,352,400 × 10%)	535,240	14,760
	Carrying amount, 12/31/87		$5,337,640

		Date	Shares	Amount
[3]	Common stock issued			
	Balance	12/31/86	800,000	$8,000,000
	5% stock dividend issued	3/2/87	40,000	400,000
	Balance	12/31/87	840,000	$8,400,000

[4]	Additional paid-in capital	
	Balance, 12/31/86	$2,295,000
	Treasury stock reissued, 1/15/87 [$225,000 − $195,000 ($325,000 × 60%)]	30,000
	Stock dividend issued, 3/2/87 [($14 − $10) × 40,000 shares]	160,000
	Balance, 12/31/87	$2,485,000

[5]	Retained earnings	
	Balance, 12/31/86	$2,465,000
	Stock dividend issued, 3/2/87 ($14 × 40,000 shares)	(560,000)
	Net income for 1987	2,860,000
	Balance, 12/31/87	$4,765,000

[6]	Net unrealized loss on noncurrent marketable equity securities Balance, 12/31/87 [($20 − $18) × 10,000 shares]	$20,000
[7]	Treasury stock at cost (10,000 ÷ 25,000 × $325,000)	$130,000
[8]	Interest expense on note payable to bank [11/1/87 to 12/31/87 ($4,000,000 × 9% × 2/12)]	$ 60,000

[9]	Interest expense on debenture bonds payable		
	Interest paid 12/31/87 for year ended 12/31/87	$550,000	[2]
	Deduct amortization of bond premium for year	14,760	[2]
	Interest expense year ended 12/31/87	$535,240	

VII. Cost Accumulation, Planning, and Control

2N91
Answer 4 (10 points)

a. 1. **DIRECT MATERIALS PRICE VARIANCE**

Actual cost	2,400 gallons @ $2.45 per gallon	$5,880	
Standard cost	2,400 gallons @ $2.50 per gallon	6,000	
Price variance		$ 120	Favorable

a. 2. **DIRECT MATERIALS USAGE VARIANCE**

Actual usage	2,400 gallons		
Standard usage: $\frac{1,800}{18,000} \times 21,000$ feet =	2,100 gallons		
Usage variance	300 gallons @ $2.50	$ 750	Unfavorable

a. 3. **DIRECT LABOR TRAVEL, SETUP, AND CLEARUP VARIANCE**

Actual cost	300 hours @ $8.00 per hour	$2,400	
Standard cost: 210 customers × 1 hour each	210 hours @ $8.00 per hour	1,680	
Variance		$ 720	Unfavorable

a. 4. **DIRECT LABOR BONUS**

Actual direct labor (tree-spraying)	910 hours @ $8.00 per hour	$7,280	
Standard direct labor: $\frac{900}{18,000} \times 21,000$ feet =	1,050 hours @ $8.00 per hour	8,400	
Direct labor efficiency variance		$1,120	Favorable
Incentive		× .75	
Bonus		$ 840	

a. 5. **OVERHEAD SPENDING VARIANCE**

Actual overhead		$5,400	
Standard overhead:			
Variable			
210 customers × ($1,200/200)	$1,260		
21,000 feet × ($1,800/18,000)	2,100		
Fixed	2,000	5,360	
Spending variance		$ 40	Unfavorable

2N91
Answer 4 (cont.)

b.

ANALYSIS TO DETERMINE ADVISABILITY OF HIRING AN ADDITIONAL EMPLOYEE

Direct labor costs of overtime for current employees	
Estimated increase in volume:	
20 additional customers with 70% probability	14
30 additional customers with 30% probability	9
Weighted average number of new customers	23
Travel, setup, and clearup	
1 hour for each of 23 new customers	23.0
Tree-spraying	
4.5 hours for each of 23 new customers	103.5
Total overtime hours	126.5
Total direct labor overtime costs	
126.5 hours × \$8 per hour × 1.25 (for 25% overtime premium)	\$1,265

vs.

Costs of hiring an additional employee	
Variable (165 hours at \$8 per hour)	\$1,320
Fixed	100
Total costs of hiring an additional employee	\$1,420

This analysis demonstrates that it would not be cost-effective for Tredoc to hire an additional employee.

2M91
Answer 5 (10 points)

a.

Spara Corp.
RELEVANT ANNUAL AFTER-TAX CASH FLOWS
CAD/CAM PROJECT

Savings on elimination of current manual system (20,000 hrs. @ $20)		$400,000
Operating costs of CAD/CAM system	$200,000	
Depreciation of CAD/CAM system ($480,000/6)	80,000	280,000
Pre-tax savings		120,000
Less income taxes ($120,000 × 30%)		36,000
Increase in reported income		84,000
Add depreciation		80,000
Increase in annual net cash flows		$164,000

b. 1. **PAYBACK PERIOD**

Cost, $480,000/Increase in annual net cash flows, $164,000	2.93 years

b. 2. **INTERNAL RATE OF RETURN**

Rate	*Annual cash flows*	*Factor*	*Present value*	*Investment*	*Difference*
24%	$164,000	3.020	$495,280	$480,000	$15,280
26%	164,000	2.885	473,140		
2%			$ 22,140		

Interpolation:

$$\frac{15{,}280}{22{,}140} \times .02 = .0138$$

Internal rate of return (.24 + .0138) = 25.38%

b. 3. **NET PRESENT VALUE**

Present value of annual net cash flows ($164,000 × 3.326)	$545,464
Less investment	480,000
Net present value	$ 65,464

b. 4. **EXCESS PRESENT VALUE INDEX**

$$\frac{\text{Present value of annual net cash flows}}{\text{Investment}} \quad \frac{\$545{,}464}{\$480{,}000} = 114\%$$

2N90
Answer 5 (10 points)

a. 1.

Lond Co.
TOTAL GROSS MARGIN
For the Year Ended December 31, 1989

	Jana	*Reta*	*Total*
Sales	$200,000	$300,000	$500,000
Cost of sales			
Joint costs ($236,000 − $6,000)			230,000
Separable costs		210,000	210,000
Total costs			440,000
Total gross margin (12%)			$ 60,000

a. 2.

Lond Co.
ALLOCATION OF JOINT COSTS
For the Year Ended December 31, 1989

	Jana	*Reta*	*Total*
Sales	$200,000	$300,000	$500,000
Less gross margin (12%)	24,000	36,000	60,000
Less separable costs		210,000	210,000
Total deductions	24,000	246,000	270,000
Joint costs	$176,000	$ 54,000	$230,000

a. 3.

Lond Co.
PRODUCT GROSS MARGINS
For the Year Ended December 31, 1989

	Jana	*Reta*	*Total*
Sales	$200,000	$300,000	$500,000
Cost of sales			
Joint costs	176,000	54,000	230,000
Separable costs		210,000	210,000
Total costs	176,000	264,000	440,000
Gross margins	$ 24,000	$ 36,000	$ 60,000

b.

Lond Co.
COMPUTATION OF BREAKEVEN POINT IN POUNDS
For the Year Ended December 31, 1989

Sales			
Jana	$200,000		
Reta	300,000		
Bynd	11,000		$511,000
Variable costs			
Joint	$ 88,000		
Reta	120,000		
Bynd	3,000		211,000
Contribution margin			$300,000
Contribution margin per pound	$300,000 / 100,000	=	$3.00
Fixed costs			
Joint	$148,000		
Reta	90,000		
Bynd	2,000		
Total fixed costs	$240,000		
Breakeven point in pounds	$240,000 / $3	=	80,000

c. 1.

Lond Co.
PROJECTED PRODUCTION IN POUNDS AT FULL CAPACITY
For the Year Ending December 31, 1990

	Jana	*Reta*	*Bynd*	*Total*
Pounds of production for the year ended December 31, 1989	50,000	40,000	10,000	100,000
Projected increases				
Jana .5 × 20,000	10,000			
Reta .4 × 20,000		8,000		
Bynd .1 × 20,000			2,000	
Total increase				20,000
Projected pounds of production at full capacity	60,000	48,000	12,000	120,000

2N90
Answer 5 (cont.)

c. 2.

Lond Co.
DIFFERENTIAL REVENUES (EXCLUDING RETA)
For the Year Ending December 31, 1990

Increase in sales of Jana at full capacity		
Projected sales for 1990 (60,000 pounds @ $3.40)	$204,000	
Sales of Jana for 1989 (50,000 pounds @ $4.00)	200,000	$4,000
Decrease in sales of Bynd at full capacity		
Projected sales for 1990 (12,000 pounds @ $0.90)	$ 10,800	
Sales of Bynd for 1989 (10,000 pounds @ $1.10)	11,000	200
Net increase in sales (excluding Reta)		$3,800

c. 3.

Lond Co.
DIFFERENTIAL COSTS
For the Year Ending December 31, 1990

Joint [(120,000 − 100,000) × ($88,000/100,000)]	$17,600
Reta [(48,000 − 40,000) × ($120,000/40,000)]	24,000
Bynd [(12,000 − 10,000) × ($3,000/10,000)]	600
Increase in differential costs	$42,200

c. 4.

Lond Co.
SALES PRICE REQUIRED PER POUND OF RETA
IN 1990
TO ACHIEVE TOTAL 1989 GROSS MARGIN

Sales of Reta for 1989	$300,000
Projected 1990 net increase in differential costs	38,400
Recovery required from Reta	$338,400

Sales price required per pound of Reta
$338,400/48,000 = $7.05

PROOF
(Not Required)

	Jana	*Reta*	*Joint*	*Total*
Projected 1990 sales	$204,000	$338,400		$542,400
Fixed costs		90,000	$148,000	238,000
Variable costs (20% higher than in 1989)		144,000	105,600	249,600
Less Bynd's net realizable value ($10,800 − 2,000 − 3,600)				(5,200)
Total costs				482,400
Gross margin (1990 and 1989)				$ 60,000

2M90
Answer 5 (10 points)

a. 1.

Lane College
PROJECTED ENROLLMENT
For the Academic Year 1990–91

		Undergraduate	*Graduate*	*Total*
Enrollment for 1989–90		4,200	1,300	5,500
Projected increase for 1990–91 — 5%		210	65	275
TA enrollment for 1990–91				
Average number of undergraduate students per class	25			
Average faculty teaching load in credit hours	×24			
Product	600			
One-half	300			
Projected increase in undergraduate enrollment for 1990–91	210			
Average number of credit hours carried by each undergraduate student	×30			
Product	6,300			
TA enrollment (6,300/300)		—	21	21
Total expected enrollment		4,410	1,386	5,796

a. 2.

Lane College
PROJECTED STUDENT CREDIT HOURS
For the Academic Year 1990–91

	Undergraduate	*Graduate*	*Total*
Expected enrollment, excluding TA's	4,410	1,365	5,775
Average number of credit hours carried by each student	×30	×24	
Credit hours, excluding TA's	132,300	32,760	165,060
TA credit hours [21 × (½ of 24)]		252	252
Total student credit hours	132,300	33,012	165,312

2M90
Answer 5 (cont.)

a. 3.

Lane College
PROJECTED NUMBER OF FULL-TIME FACULTY AND TA'S
For the Academic Year 1990–91

		Full-time	*TA's*
For undergraduate program			
Enrollment for 1989–90	4,200		
Average number of credit hours carried by each student	×30		
Total undergraduate credit hours	126,000		
Average number of undergraduate students per class	25		
Average faculty teaching load in credit hours	×24		
Total credit hours taught by faculty	600		
Required full-time faculty (126,000/600)		210	
TA's for projected increase in undergraduate enrollment for 1990–91:			
Projected enrollment increase	210		
Average number of credit hours carried by each student	×30		
Increased number of credit hours	6,300		
Average faculty teaching load	600		
One-half carried by TA's	×.5		
TA teaching load	300		
Required number of TA's (6,300/300)			21
For graduate program			
Enrollment for 1990–91 (excluding TA's)	1,365		
Average number of credit hours carried by each student	×24		
Graduate credit hours (excluding TA's)	32,760		
TA credit hours [21 × (½ of 24)]	252		
Total graduate credit hours	33,012		
Average number of students per class	14		
Average faculty teaching load	×18		
Total credit hours taught by faculty	252		
Required full-time faculty (33,012/252)		131	—
Total required full-time faculty and TA's		341	21

a. 4.

Lane College
PROJECTED SALARIES AND BENEFITS
FOR FULL-TIME FACULTY AND TA'S
For the Academic Year 1990–91

	Faculty		
	Undergraduate	*Graduate*	*Total*
Full-time 210 × ($50,000 × 1.03)	$10,815,000		$10,815,000
TA's 21 × $10,000	210,000		210,000
Full-time 131 × ($60,000 × 1.03)		$8,095,800	8,095,800
Total salaries and benefits	$11,025,000	$8,095,800	$19,120,800

a. 5.

Lane College
PROJECTED TUITION REVENUE
For the Academic Year 1990–91

Undergraduate	
132,300 student credit hours × $200 per credit hour	$26,460,000
Graduate	
33,012 student credit hours × $300 per credit hour	9,903,600
Total projected tuition revenue	$36,363,600

b. 1.

Lane College
FIXED AND VARIABLE ELEMENTS
IN NON-FACULTY COSTS
For the Academic Year 1990–91

Estimated non-faculty costs at level of 180,000 credit hours		$22,320,000
Estimated non-faculty costs at level of 140,000 credit hours		21,960,000
Difference between two levels	40,000	$ 360,000

Variable costs per credit hour = 360,000/40,000 = $9
Fixed costs = $22,320,000 − $9 (180,000) = $20,700,000
or
$21,960,000 − $9 (140,000) = $20,700,000

b. 2.

Lane College
BUDGETED NON-FACULTY COSTS
For the Academic Year 1990–91

Fixed costs	$20,700,000
Variable costs (165,312 credit hours × $9)	1,487,808
Scholarships (21 TA's × 12 credits × $300 per credit)	75,600
Total budgeted non-faculty costs	$22,263,408

2M89
Answer 5 (10 points)

a.

Tapa Wholesale Company
PRICING FUNCTION BUDGET
For the Year Ending December 31, 1989

Variable costs:	
Wages	$66,000
Payroll taxes	6,600
Workers' compensation insurance	3,300
Supplies	1,500
Total variable costs	77,400
Fixed costs	3,400
Total costs	$80,800

COMPUTATIONS

Wages	
Number of items priced in 1988 (20,000 × 4)	80,000
Projected number of items priced in 1989 (24,000 × 5)	120,000
Average wage cost per item in 1988 ($40,000/80,000)	$0.50
Projected wage cost in 1989 (120,000 @ $0.50 + 10%)	$66,000
Payroll taxes	
$66,000 × 10%	$ 6,600
Workers' compensation insurance	
$66,000 × 5%	$ 3,300
Supplies	
1989 projected multiple of number of 1988 items (120,000/80,000)	1.5 times
$1,000 × 1.5	$ 1,500

b.

Tapa Wholesale Company
COMPUTATION OF STANDARD DELIVERY COST PER UNIT OF PRODUCT
For the Year Ending December 31, 1989

Product	*Units*	*Unit capacity per truck*	*Number of deliveries projected*	*Variable costs per delivery*	*Variable costs per unit delivered*	*Fixed costs*	*Total*
Arcil	60,000	10	6,000	$12	$1.20	$0.25	$1.45
Balo	40,000	5	8,000	12	2.40	0.25	2.65
Cacha	20,000	4	5,000	12	3.00	0.25	3.25
Totals	120,000		19,000				

Variable cost per delivery:		Fixed costs per unit:	
Total number of deliveries	19,000	Total number of units	120,000
Variable costs	$228,000	Fixed costs	$30,000
Variable costs per delivery	$12	Fixed costs per unit	$0.25

2N88
Answer 5 (10 points)

a.

Amar Supermarkets Corp.
Plan 1
ALLOCATION OF CORPORATION OVERHEAD ON THE BASIS OF SALES
For the Year Ended December 31, 1987

Store	*Allocation*	*Corporation overhead*	*Income before corporation overhead*	*Income after corporation overhead*
Birch	$^5/_{12}$ = 42%	$ 42,000	$ 84,000	$42,000
Maple	$^4/_{12}$ = 33%	33,000	37,000	4,000
Spruce	$^3/_{12}$ = 25%	25,000	29,000	4,000
Totals		$100,000	$150,000	$50,000

Plan 2
ALLOCATION OF CORPORATION OVERHEAD ON VARIOUS BASES
For the Year Ended December 31, 1987

			Store		
	Total	*Warehouse operations*	*Birch*	*Maple*	*Spruce*
Income before corporation overhead	$150,000		$84,000	$37,000	$29,000
Warehouse operations	15,000	$15,000			
Central office salaries	30,000	7,500	7,500	7,500	7,500
Other central office overhead	2,000	500	500	500	500
Total warehouse operations	23,000	$23,000			
Warehouse depreciation	10,000				
Advertising	8,000				
Total — allocated on basis of sales	41,000		17,220	13,530	10,250
Delivery expenses — allocated on basis of miles times deliveries	35,000				
15,000/30,000 = 50%			17,500		
10,000/30,000 = 33%				11,550	
5,000/30,000 = 17%					5,950
Total corporation overhead	100,000		42,720	33,080	24,200
Income after corporation overhead	$ 50,000		$41,280	$ 3,920	$ 4,800

2N88
Answer 5 (cont.)

b.

Amar Supermarkets Corp.
COMPUTATION OF COST INCREASES
RESULTING FROM PROSPECTIVE INCREASE IN SALES

	Birch	*Maple*	*Spruce*	*Total*
Sales — 1987	$500,000	$400,000	$300,000	$1,200,000
Cost of sales — 1987	$280,000	$230,000	$190,000	$ 700,000
Local variable operating expenses	66,000	73,000	31,000	170,000
Total local variable costs	$346,000	$303,000	$221,000	$ 870,000
Percent of local variable costs to sales	69%	76%	74%	
Multiplied by prospective increase in sales	$ 80,000	$ 80,000	$ 80,000	
Increase in local variable costs	55,200	60,800	59,200	
*Increase in delivery expenses	1,170	2,340	293	
Increase in relevant expenses (local variable costs and delivery)	$ 56,370	$ 63,140	$ 59,493	

Management should expand the Birch store because costs would increase the least and net income would increase the most. Differential revenues would be the same for all stores, but differential costs would be the least at Birch. Therefore, differential net income would be greatest at Birch.

*COMPUTATION OF INCREASE IN DELIVERY EXPENSES

Store	*Miles from warehouse*	*Additional deliveries*	*Additional delivery miles*	*Cost per delivery mile*	*Total increase*
Birch	100	10	1,000	$1.17	$1,170
Maple	200	10	2,000	1.17	2,340
Spruce	25	10	250	1.17	293

$$\text{Cost per delivery mile} = \frac{\text{Delivery expenses in 1987}}{\text{Delivery miles in 1987}} = \frac{\$35{,}000}{30{,}000} = \underline{\underline{\$1.17}}$$

2M88
Answer 5 (10 points)

Seco Corp.
Year Ending December 31, 1989

a. Estimated Breakeven Point Based on Pro Forma Income Statement

Sales		$10,000,000
Variable costs		
Cost of sales	$6,000,000	
Commissions	2,000,000	8,000,000
Contribution margin		$ 2,000,000
Contribution margin ratio ($2,000,000 ÷ $10,000,000)		20%
Fixed costs		$ 100,000
Contribution margin ratio		÷ .20
Estimated breakeven point		$ 500,000

b. Estimated Breakeven Point With Company Employing Its Own Salespersons

Variable cost ratios	
Cost of sales	60%
Commissions	5%
Total	65%
Contribution margin ratio (100%–65%)	35%
Fixed costs	
Sales manager	$ 160,000
3 salespersons @ $30,000 each	90,000
Administrative	100,000
Total	$ 350,000
Fixed costs	$ 350,000
Contribution margin ratio	÷ .35
Estimated breakeven point	$ 1,000,000

2M88
Answer 5 (cont.)

c.

Estimated Sales Volume Yielding Net Income Projected in Pro Forma Income Statement With Independent Sales Agents Receiving 25% Commission

Target income before income tax	$ 1,900,000
Fixed costs	100,000
Total	$ 2,000,000
Variable cost ratios	
Cost of sales	60%
Commissions	25%
Total	85%
Contribution margin ratio (100% − 85%)	15%
Target income + fixed costs	$ 2,000,000
Contribution margin ratio	÷ .15
Estimated sales volume	$13,333,333

d.

Estimated Sales Volume Yielding An Identical Net Income Regardless of Whether the Company Employs Its Own Salespersons or Continues With Independent Sales Agents and Pays Them 25% Commission

Total costs with agents receiving 25% commission = Total costs with company's own sales force

X = sales volume

$$\frac{\$\,8{,}500{,}000}{\$10{,}000{,}000}X + \$100{,}000 = \frac{\$\,6{,}500{,}000}{\$10{,}000{,}000}X + \$350{,}000$$

$$.85X + \$100{,}000 = .65X + \$350{,}000$$

$$.20X = \$250{,}000$$

$$X = \$1{,}250{,}000$$

VIII. Not-for-Profit and Governmental Accounting

2N91
Answer 5 (10 points)

a.

Eden Township
ADMINISTRATION CENTER CAPITAL PROJECTS FUND
Journal Entries
July 1, 1990 to June 30, 1991

			Debit	*Credit*
1990				
July	1	Cash	$ 300,000	
		Due to general fund		$ 300,000
		To record loan received from general fund		
	9	Expenditures	200,000	
		Cash		200,000
		To record unencumbered expenses		
Dec.	1	Cash	6,060,000	
		Other financing sources		6,060,000
		To record sale of bonds		
	1	Due from state government	3,000,000	
		Revenues		3,000,000
		To record grant due from state		
1991				
Apr.	30	Encumbrances	7,000,000	
		Reserved for encumbrances		7,000,000
		To record encumbrance for contract		
May	9	Cash	1,000,000	
		Due from state government		1,000,000
		To record receipt of grant		
June	10	Due to general fund	300,000	
		Cash		300,000
		To record payment of loan		
	30	Reserved for encumbrances	1,200,000	
		Encumbrances		1,200,000
		To reverse encumbrance for progress billing on contract		
	30	Expenditures	1,200,000	
		Contracts payable		1,152,000
		Retainage payable		48,000
		To record expenditures on construction contract and retained amount		

2N91
Answer 5 (cont.)

b.

Eden Township
ADMINISTRATION CENTER CAPITAL PROJECTS FUND
Closing Entries
June 30, 1991

	Debit	Credit
(1)		
Fund balance	$7,200,000	
Encumbrances		$5,800,000
Expenditures		1,400,000
To close		
(2)		
Revenues	3,000,000	
Other financing sources	6,060,000	
Fund balance		9,060,000
To close		

c.

Eden Township
ADMINISTRATION CENTER CAPITAL PROJECTS FUND
BALANCE SHEET
June 30, 1991

Assets

Cash		$6,860,000
Due from state government		2,000,000
Total assets		$8,860,000

Liabilities and Fund Balance

Liabilities:		
Contracts payable	$1,152,000	
Retainage payable	48,000	
Total liabilities		$1,200,000
Fund balance:		
Reserved for encumbrances	5,800,000	
Unreserved — designated for construction	1,860,000	
Total fund balance		7,660,000
Total liabilities and fund balance		$8,860,000

2M91
Answer 4 (10 points)

Candidate's No. ________
State ________
Question No. 4 **Page** ________

Albury City
WORKSHEET TO CORRECT TRIAL BALANCE
December 31, 1990

	Trial balance	*Adjustments Debit*	*Adjustments Credit*	*General fund*	*Debt service fund*	*Capital projects fund*	*Account groups: General fixed assets*	*Account groups: General long-term debt*
Debits:								
Cash	$477,800			$ 71,800	$6,000	$400,000		
Expenditures	145,000	$ 28,000 [b]		173,000				
Estimated revenues	228,200			228,200				
Equipment		66,000 [c]					$66,000	
Encumbrances		10,000 [d]		10,000				
Supplies inventory		3,400 [e]		3,400				
Taxes receivable—current		24,000 [a]		24,000				
Amount to be provided for retirement of term bonds		394,000 [g]						$394,000
Amounts available in debt service fund—term bonds		6,000 [g]						6,000
Totals	$851,000			$510,400	$6,000	$400,000	$66,000	$400,000
Credits:								
Appropriations	$204,000			$204,000				
Revenues and other financing sources	216,800		$ 13,200 [a] 406,000 [f]	230,000	$6,000	$400,000		
Bonds payable	400,000	400,000 [f]	400,000 [g]					$400,000
Premium on bonds payable	6,000	6,000 [f]						
Fund balance	24,200			24,200				
Vouchers payable			28,000 [b]	28,000				
Investment in general fixed assets—general fund revenue			66,000 [c]				$66,000	
Reserved for encumbrances			10,000 [d]	10,000				
Reserved for supplies inventory			3,400 [e]	3,400				
Estimated uncollectible current taxes			10,800 [a]	10,800				
Totals	$851,000	$937,000	$937,400	$510,400	$6,000	$400,000	$66,000	$400,000

2M91
Answer 4 (cont.)

Albury City
WORKSHEET ADJUSTMENTS
December 31, 1990
(Not Required)

		Debit	*Credit*
[a]	Taxes receivable — current	$ 24,000	
	Estimated uncollectible current taxes		$ 10,800
	Revenues		13,200
	To record current taxes receivable and amount estimated as uncollectible, computed as follows:		

Total tax levy / Divided by % collectible: $\frac{\$205,200}{.95} = \$216,000$

Taxes receivable = \$216,000 − \$192,000 = \$ 24,000

Estimated uncollectible taxes = 5% × \$216,000 = \$ 10,800

		Debit	*Credit*
[b]	Expenditures	28,000	
	Vouchers payable		28,000
	To record liabilities unrecorded at year-end.		
[c]	Equipment	66,000	
	Investment in general fixed assets — general fund revenue		66,000
	To record purchase of equipment from general fund revenue.		
[d]	Encumbrances	10,000	
	Reserved for encumbrances		10,000
	To record purchase orders outstanding at year-end.		
[e]	Supplies inventory	3,400	
	Reserved for supplies inventory		3,400
	To record inventory of supplies on hand at year-end.		
[f]	Bonds payable	400,000	
	Premium on bonds payable	6,000	
	Other financing sources		406,000
	To reclassify bond proceeds.		
[g]	Amount to be provided for retirement of term bonds	394,000	
	Amounts available in debt service fund — term bonds	6,000	
	Bonds payable		400,000
	To record bond issue and amount restricted for bond retirement.		

2N89
Answer 4 (10 points)

Children's Agency
JOURNAL ENTRIES
For the Year Ended June 30, 1989

Account Title	*Current Fund* *Unrestricted* *Dr. (Cr.)*	*Current Fund* *Restricted* *Dr. (Cr.)*	*Land, Buildings, and Equipment Fund* *Dr. (Cr.)*	*Endowment Fund* *Dr. (Cr.)*
1. Pledges receivable	$800,000		$50,000	
Cash		$95,000		$1,000
Contributions	(800,000)	(95,000)	(50,000)	(1,000)
2. Cash	450,000		20,000	
Pledges receivable	(450,000)		(20,000)	
3. Cash	35,000			
Special events support	(12,000)			
Legacies and bequests	(10,000)			
Membership dues	(8,000)			
Investment revenue	(5,000)			
4. Medical services program	60,000			
Community information services program	15,000			
Vouchers payable	(75,000)			
5. Management and general services	150,000			
Fund-raising services	200,000			
Vouchers payable	(350,000)			
6. Transfer to land, buildings,				
and equipment fund	18,000			
Cash	(18,000)			
Buildings and equipment			18,000	
Fund balance — expended			(18,000)	
7. Depreciation expense			15,000	
Accumulated depreciation			(15,000)	
Fund-balance — expended			15,000	
Fund balance — unexpended			(15,000)	
Medical services program			4,000	
Community information services program			3,000	
Management and general services			6,000	
Fund raising services			2,000	
Depreciation expense			(15,000)	
8. Vouchers payable	330,000			
Cash	(330,000)			

IX. Federal Taxation—Individuals, Estates, and Trusts

2M90
Answer 4 (10 points)

a. Earl Mayne can use joint return rates in computing his 1989 federal income tax because he qualifies as a "surviving spouse."

b.

Earl Mayne
COMPUTATION OF TAXABLE INCOME
For the Year Ended December 31, 1989

Income			
Salaries ($60,000 + $3,000)			$63,000
Interest			800
Dividends			875
Short-term capital loss			
Nonbusiness bad debt		$ 2,500	
Settlement proceeds		350	
Balance			(2,150)
Proceeds from sale of residence		97,402	
Less basis		14,000	
Gain		83,402	
Exclusion		83,402	
Balance			-0-
Gross rents		1,200	
Less realty expenses		(2,000)	
Loss		(800)	
Passive activity disallowance		800	
Balance			-0-
Other exclusions from gross income			
Life insurance proceeds		5,000	
Dividends on life insurance policy		410	
Total		5,410	
Adjusted gross income			62,525
Itemized deductions			
Taxes			
State income tax	$2,000		
Real estate tax	1,500		
Total		$ 3,500	
Contributions		2,250	
Miscellaneous deductions			
Professional education	900		
Professional dues	250		
Tax return preparation fee	500		
Total	1,650		
Less 2% of $62,525	1,251		
Balance		399	
Total itemized deductions			6,149
Balance			56,376
Exemptions (3 × $2,000)			6,000
TAXABLE INCOME			$50,376

c. **COMPUTATION OF FEDERAL INCOME TAX OVERPAYMENT**

Tax before payments on account		$10,082
Payments on account		
Tax withheld ($10,000 + $100)	$10,100	
Excess FICA tax	225	
Estimated tax ($4,000 + $70)	4,070	14,395
OVERPAYMENT		$ 4,313

2N89
Answer 5 (10 points)

a.

Fred and Laura Shaw
COMPUTATION OF TAXABLE INCOME
For the Year Ended December 31, 1988

Income				
Salary — Fred				$80,000
Salary — Laura				15,000
Interest				100
Dividends				527
Social security benefits (½ of $12,000)				6,000
Unemployment compensation				600
Long-term capital loss (Basis $9,000; sales price $2,500; allowable loss limited to $3,000)				(3,000)
Adjusted gross income				99,227
Itemized deductions				
Taxes				
State income taxes ($4,000 + $120)		$ 4,120		
Real estate taxes ($3,000 + $800)		3,800	$ 7,920	
Interest ($2,300 + $1,800)			4,100	
Contributions (fair market value)			1,400	
Casualty loss				
Decline in market value after fire		16,000		
Less 10% of $99,227	$9,923			
"Floor"	100	10,023	5,977	
Miscellaneous deductions				
Business travel		900		
Professional education		700		
Professional dues		150		
Tax return preparation fee		250		
Total		2,000		
Less 2% of $99,227		1,985	15	
Total itemized deductions				19,412
Balance				79,815
Exemptions (3 × $1,950)				5,850
TAXABLE INCOME				$73,965

2N89
Answer 5 (cont.)

b. **COMPUTATION OF FEDERAL INCOME TAX OVERPAYMENT**

Tax before payments on account		$16,946
Payments on account		
Tax withheld ($17,000 + $2,800)	$19,800	
Estimated tax ($2,000 + $43)	2,043	21,843
AMOUNT OVERPAID		$ 4,897

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

2M92
Answer 5 (10 points)

a.

Ral Corp.
SCHEDULE OF TAXABLE INCOME
For the Year Ended December 31, 1991

Sales			$1,000,000
Cost of sales			700,000
Gross profit			300,000
Expenses:			
Per books		$220,000	
Excess of estimated over actual bad debts	$2,000		
Keyman life insurance premiums	4,000	6,000	214,000
Balance before other income			86,000
Dividend income:			
Clove Corp. ($7,000 × 20%)	$1,400		
Ramo Corp. ($6,000 × 30%)	1,800		
Sol Corp. ($1,000 × 100%)	1,000		
Real Estate Investment Trust (fully taxable)	2,700		
Money Market Fund (fully taxable)	2,100	$ 9,000	
Interest income		5,000	14,000
Taxable income			$ 100,000

b.

Ral Corp.
COMPUTATION OF FEDERAL INCOME TAX
For the Year Ended December 31, 1991

Taxable income	$100,000
Income tax	
[$13,750 + (34% × $25,000)]	$ 22,250
Estimated tax paid	35,000
Overpayment	$ 12,750

c.

Ral Corp.
RECONCILIATION OF INCOME PER BOOKS WITH INCOME PER RETURN
For the Year Ended December 31, 1991

Income per books		$ 98,000	Income recorded on books not included on return:	
Excess of capital losses over capital gains		6,000	Dividends	$ 9,800
			Interest	200
Expenses recorded on books not deducted on return:			Subtotal	10,000
Bad debts	$2,000			
Life insurance premiums	4,000	6,000	Taxable income — $110,000 less $10,000	$100,000
Subtotal		$110,000		

2N90
Answer 4 (10 points)

Candidate's No. ____________
State ____________
Question No. 4 **Page** ____________

a.

Esa, Inc.
WORKSHEET TO CONVERT
BOOK AMOUNTS TO TAX RETURN AMOUNTS
For the Year Ended December 31, 1989

	Per books	*Adjustments*	*S Corporation tax return*	*Schedule K-1*
Income				
Sales	500,000		500,000	
Cost of goods sold	300,000		300,000	
Gross profit	200,000		200,000	
Deductions				
Compensation of officer	90,000		90,000	
Uncollectible accounts	7,000	(5,100)	1,900	
Taxes	25,000	(2,600)	22,400	2,200
Depreciation	14,000	(10,000)	4,000	10,000
Contributions	5,000	(5,000)		5,000
Employee benefit programs	19,000	(6,000)	13,000	6,000
Amortization of organization costs	300		300	
Other	20,700	(8,000)	12,700	
Total deductions	181,000	(36,700)	144,300	
Operating income	19,000	36,700	55,700	55,700
Net rental revenue	18,000		18,000	18,000
Portfolio revenue				
Interest	5,600		5,600	5,600
Dividends	3,000		3,000	3,000
Short-term capital gain	9,000		9,000	9,000
Total income	54,600			

b. The due date for the filing of Esa's 1989 S Corporation Income Tax Return is March 15, 1990.

2M89
Answer 4 (10 points)

Elm Corp.
FEDERAL TAXABLE INCOME
For the Year Ended December 31, 1988

Sales (net)			$5,500,000	[1]
Cost of goods sold			3,900,000	[8]
Gross profit			1,600,000	
Dividends			10,000	
Other income				
From partnership	$63,000	[5]		
Recapture of bad debt reserve	30,000	[10]	93,000	
Total income			1,703,000	
Compensation of officers			125,000	[9]
Salaries and wages			446,000	[9]
Bad debts			9,000	[10]
Taxes			100,000	[11]
Interest			20,000	[12]
Contributions			89,500	[13]
Depreciation			90,000	[14]
Other deductions			18,000	[15]
Total deductions			897,500	
Taxable income before special deduction			805,500	
Special deduction			7,000	[2]
Taxable income			$ 798,500	

EXPLANATIONS AND COMPUTATIONS

[1] Net sales — no adjustment.
[2] Dividends — $10,000 × 70% dividends-received deduction = $7,000.
[3] Interest — not taxable.
[4] Gain on sale of stock — offset by share of partnership long-term capital loss. Excess capital loss not deductible.
[5] Equity in earnings of Luz Partnership — $50,000 + $13,000 = $63,000.
[6] Key-man life insurance proceeds — not taxable.
[7] Tax refund — not taxable.
[8] Cost of goods sold — no adjustment.
[9] Salaries and wages — separate $125,000 officers' compensation.
[10] Doubtful accounts — limited to $9,000 actual bad debts. One-fourth of $120,000 "reserve" at December 31, 1986 = $30,000 income.
[11] Taxes — no adjustment.
[12] Interest — no adjustment.
[13] Contributions:

Taxable income	$798,500
Dividends-received deduction	7,000
Contributions deduction	89,500
Total	895,000
Allowable — 10%	$ 89,500

[14] Depreciation — no adjustment.
[15] Other — $30,000 less $12,000 life insurance premiums = $18,000.
[16] Federal income tax — not deductible.

Uniform CPA Examination/May 1988 – May 1992

Accounting Theory

Selected Questions And Unofficial Answers Indexed To Content Specification Outline

TABLE OF CONTENTS

* No multiple choice items, other objective answer formats, or essays were indexed for this area or group.

† Questions in this area are not classified according to group.

MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

A. Authority of Pronouncements

M92#1. FASB Interpretations of Statements of Financial Accounting Standards have the same authority as the FASB

a. Statements of Financial Accounting Concepts.
b. Emerging Issues Task Force Consensus.
c. Technical Bulletins.
d. Statements of Financial Accounting Standards.

B. Conceptual Framework

M92#2. According to the FASB conceptual framework, which of the following is an essential characteristic of an asset?

a. The claims to an asset's benefits are legally enforceable.
b. An asset is tangible.
c. An asset is obtained at a cost.
d. An asset provides future benefits.

M92#3. According to the FASB conceptual framework, predictive value is an ingredient of

	Reliability	*Relevance*
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

N91#1. FASB's conceptual framework explains both financial and physical capital maintenance concepts. Which capital maintenance concept is applied to currently reported net income, and which is applied to comprehensive income?

	Currently reported net income	*Comprehensive income*
a.	Financial capital	Physical capital
b.	Physical capital	Physical capital
c.	Financial capital	Financial capital
d.	Physical capital	Financial capital

M91#1. Under FASB Statement of Financial Accounting Concepts No. 5, which of the following items would cause earnings to differ from comprehensive income for an enterprise in an industry **not** having specialized accounting principles?

a. Unrealized loss on investments in noncurrent marketable equity securities.
b. Unrealized loss on investments in current marketable equity securities.
c. Loss on exchange of similar assets.
d. Loss on exchange of dissimilar assets.

N90#1. According to the FASB's conceptual framework, the process of reporting an item in the financial statements of an entity is

a. Recognition.
b. Realization.
c. Allocation.
d. Matching.

N89#1. According to the FASB's conceptual framework, comprehensive income includes which of the following?

	Gross margin	*Operating income*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M89#1. According to the FASB's conceptual framework, comprehensive income includes which of the following?

	Operating income	*Investments by owners*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#1. According to the FASB's conceptual framework, asset valuation accounts are

a. Assets.
b. Neither assets **nor** liabilities.
c. Part of stockholders' equity.
d. Liabilities.

M88#1. According to the FASB's conceptual framework, the calculation of comprehensive income includes which of the following?

	Income from continuing operations	*Distributions to owners*
a.	No	No
b.	Yes	No
c.	Yes	Yes
d.	No	Yes

M88#2. The FASB's conceptual framework classifies gains and losses based on whether they are related to an entity's major ongoing or central operations. These gains or losses may be classified as

	Nonoperating	*Operating*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

E. Consolidated Financial Statements

N91#9. Pride, Inc. owns 80% of Simba, Inc.'s outstanding common stock. Simba, in turn, owns 10% of Pride's outstanding common stock. What percentage of the common stock cash dividends declared by the individual companies should be reported as dividends declared in the consolidated financial statements?

	Dividends declared by Pride	*Dividends declared by Simba*
a.	90%	0%
b.	90%	20%
c.	100%	0%
d.	100%	20%

N90#2. Water Co. owns 80% of the outstanding common stock of Fire Co. On December 31, 1989, Fire sold equipment to Water at a price in excess of Fire's carrying amount, but less than its original cost. On a consolidated balance sheet at December 31, 1989, the carrying amount of the equipment should be reported at

a. Water's original cost.
b. Fire's original cost.
c. Water's original cost less Fire's recorded gain.
d. Water's original cost less 80% of Fire's recorded gain.

M90#2. P Co. purchased term bonds at a premium on the open market. These bonds represented 20 percent of the outstanding class of bonds issued at a discount by S Co., P's wholly owned subsidiary. P intends to hold the bonds until maturity. In a consolidated balance sheet, the difference between the bond carrying amounts in the two companies would be

a. Included as a decrease to retained earnings.
b. Included as an increase to retained earnings.
c. Reported as a deferred debit to be amortized over the remaining life of the bonds.
d. Reported as a deferred credit to be amortized over the remaining life of the bonds.

M88#3. A subsidiary was acquired for cash in a business combination on January 1, 1987. The purchase price exceeded the fair value of identifiable net assets. The acquired company owned equipment with a market value in excess of the carrying amount as of the date of combination. A consolidated balance sheet prepared on December 31, 1987, would

a. Report the unamortized portion of the excess of the market value over the carrying amount of the equipment as part of goodwill.
b. Report the unamortized portion of the excess of the market value over the carrying amount of the equipment as part of plant and equipment.
c. Report the excess of the market value over the carrying amount of the equipment as part of plant and equipment.
d. Not report the excess of the market value over the carrying amount of the equipment because it would be expensed as incurred.

F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

M92
Items 4 and 5 are based on the following:

In a period of rising general price levels, Pollard Corp. discloses income on a current cost basis in accordance with FASB Statement No. 89, *Financial Reporting and Changing Prices.*

4. Compared to historical cost income from continuing operations, which of the following conditions increases Pollard's current cost income from continuing operations?

a. Current cost of equipment is greater than historical cost.
b. Current cost of land is greater than historical cost.
c. Current cost of cost of goods sold is less than historical cost.
d. Ending net monetary assets are less than beginning net monetary assets.

5. Which of the following contributes to Pollard's purchasing power loss on net monetary items?

a. Refundable deposits with suppliers.
b. Equity investment in unconsolidated subsidiaries.
c. Warranty obligations.
d. Wages payable.

N91#7. Generally, which inventory costing method approximates most closely the current cost for each of the following?

	Cost of goods sold	*Ending inventory*
a.	LIFO	FIFO
b.	LIFO	LIFO
c.	FIFO	FIFO
d.	FIFO	LIFO

M91#2. Could current cost financial statements report holding gains for goods sold during the period and holding gains on inventory at the end of the period?

	Goods sold	*Inventory*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M91#3. When computing purchasing power gain or loss on net monetary items, which of the following accounts is classified as nonmonetary?

a. Unamortized premium on bonds payable.
b. Accumulated depreciation of equipment.
c. Advances to unconsolidated subsidiaries.
d. Allowance for uncollectible accounts.

N90#11. During a period of inflation, an account balance remains constant. When supplemental statements are being prepared, a purchasing power gain is reported if the account is a

a. Monetary asset.
b. Monetary liability.
c. Nonmonetary asset.
d. Nonmonetary liability.

M90#3. During a period of inflation, the specific price of a parcel of land increased at a lower rate than the consumer price index. The accounting method that would measure the land at the highest amount is

a. Historical cost/nominal dollar.
b. Current cost/nominal dollar.
c. Current cost/constant dollar.
d. Historical cost/constant dollar.

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

M92#42. A marketable equity security is transferred from the current portfolio to the noncurrent portfolio. At the transfer date, the security's cost exceeds its market value. What amount is used at the transfer date to record the security in the noncurrent portfolio?

a. Market value, regardless of whether the decline in market value below cost is considered permanent or temporary.
b. Market value, only if the decline in market value below cost is considered permanent.
c. Cost, if the decline in market value below cost is considered temporary.
d. Cost, regardless of whether the decline in market value below cost is considered permanent or temporary.

N91#36. An issuer of bonds uses a sinking fund for the retirement of the bonds. Cash was transferred to the sinking fund and subsequently used to purchase investments. The sinking fund

I. Increases by revenue earned on the investments.
II. Is **not** affected by revenue earned on the investments.
III. Decreases when the investments are purchased.

a. I only.
b. I and III.
c. II and III.
d. III only.

M91#4. An investor purchased a bond classified as a long-term investment between interest dates at a discount. At the purchase date, the carrying amount of the bond is more than the

	Cash paid to seller	*Face amount of bond*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N90#6. On December 29, 1989, BJ Co. sold a marketable equity security that had been purchased on January 4, 1988. BJ owned no other marketable equity security. An unrealized loss was reported in the 1988 income statement. A realized gain was reported in the 1989 income statement. Was the marketable equity security classified as a noncurrent asset and did its 1988 market price decline exceed its 1989 market price recovery?

	Noncurrent	*1988 market price decline exceeded 1989 market price recovery*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M90#4. When the market value of an investment in debt securities exceeds its carrying amount, how should each of the following assets be reported at the end of the year?

	Short-term marketable debt securities	*Long-term marketable debt securities*
a.	Market value	Market value
b.	Carrying amount	Carrying amount
c.	Carrying amount	Market value
d.	Market value	Carrying amount

N89#2. Robin Co. has a marketable equity securities portfolio classified as noncurrent. None of the holdings enables Robin to exercise significant influence over an investee. The aggregate cost exceeds its aggregate market value. The decline is considered temporary and should be reported as a(an)

a. Unrealized loss in the income statement.
b. Realized loss in the income statement.
c. Valuation allowance in the noncurrent liability section of the balance sheet.
d. Valuation allowance in the asset section of the balance sheet.

N89#3. An investor purchased a bond as a long-term investment on January 2. The investor's carrying value at the end of the first year would be highest if the bond was purchased at a

a. Discount and amortized by the straight-line method.
b. Discount and amortized by the effective interest method.
c. Premium and amortized by the straight-line method.
d. Premium and amortized by the effective interest method.

N89#4. An investor in common stock received dividends in excess of the investor's share of investee's earnings subsequent to the date of the investment. How will the investor's investment account be affected by those dividends under each of the following accounting methods?

	Cost method	*Equity method*
a.	No effect	No effect
b.	Decrease	No effect
c.	No effect	Decrease
d.	Decrease	Decrease

N89#5. On January 2, 1985, a company established a sinking fund in connection with an issue of bonds due in 1995. At December 31, 1988, the independent trustee held cash in the sinking fund account representing the annual deposits to the fund and the interest earned on those deposits. How should the sinking fund be reported in the company's classified balance sheet at December 31, 1988?

a. The entire balance in the sinking fund account should appear as a noncurrent asset.
b. The entire balance in the sinking fund account should appear as a current asset.
c. The cash in the sinking fund should appear as a current asset.
d. The accumulated deposits only should appear as a noncurrent asset.

N88#2. The amount by which the aggregate cost of a marketable equity securities portfolio exceeds its aggregate market value should be reported as a valuation allowance when the portfolio is included

	As a current asset	*In an unclassified balance sheet*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#3. A short-term marketable debt security was purchased on September 1, 1987, between interest dates. The next interest payment date was February 1, 1988. Because of a permanent decline in market value, the cost of the debt security substantially exceeded its market value at December 31, 1987. On the balance sheet at December 31, 1987, the debt security should be carried at

a. Market value plus the accrued interest paid.
b. Market value.
c. Cost plus the accrued interest paid.
d. Cost.

N88#4. An investor purchased a bond as a long-term investment between interest dates at a premium. At the purchase date, the cash paid to the seller is

a. The same as the face amount of the bond.
b. The same as the face amount of the bond plus accrued interest.
c. More than the face amount of the bond.
d. Less than the face amount of the bond.

N88#5. An investor uses the equity method to account for an investment in common stock. After the date of acquisition, the investment account of the investor would

a. Not be affected by its share of the earnings or losses of the investee.
b. Not be affected by its share of the earnings of the investee, but be decreased by its share of the losses of the investee.

c. Be increased by its share of the earnings of the investee, but **not** be affected by its share of the losses of the investee.
d. Be increased by its share of the earnings of the investee, and decreased by its share of the losses of the investee.

M88#5. The amount by which the aggregate market value of a marketable equity securities portfolio exceeds its cost should be accounted for as a valuation allowance when the portfolio is classified as

	Current	*Noncurrent*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#6. An issuer of bonds is required by its bond indenture agreement to use a sinking fund for the retirement of the bonds. Cash was transferred to the sinking fund. The sinking fund cash was then used to purchase investments. The sinking fund

a. Increases when the investments are purchased.
b. Decreases when the investments are purchased.
c. Increases by revenue earned on the investments.
d. Is **not** affected by revenue earned on the investments.

B. Receivables and Accruals

M92#21. On August 15, 1991, Benet Co. sold goods for which it received a note bearing the market rate of interest on that date. The four-month note was dated July 15, 1991. Note principal, together with all interest, is due November 15, 1991. When the note was recorded on August 15, which of the following accounts increased?

a. Unearned discount.
b. Interest receivable.
c. Prepaid interest.
d. Interest revenue.

M92#41. In its financial statements, Pulham Corp. uses the equity method of accounting for its 30% ownership of Angles Corp. At December 31, 1991, Pulham has a receivable from Angles. How should the receivable be reported in Pulham's 1991 financial statements?

a. None of the receivable should be reported, but the entire receivable should be offset against Angles' payable to Pulham.
b. Seventy percent of the receivable should be separately reported, with the balance offset against 30% of Angles' payable to Pulham.
c. The total receivable should be disclosed separately.
d. The total receivable should be included as part of the investment in Angles, without separate disclosure.

M92#47. When the allowance method of recognizing uncollectible accounts is used, the entries at the time of collection of a small account previously written off would

a. Increase the allowance for uncollectible accounts.
b. Increase net income.
c. Decrease the allowance for uncollectible accounts.
d. Have **no** effect on the allowance for uncollectible accounts.

N91#6. For financial statement purposes, the installment method of accounting may be used if the

a. Collection period extends over more than 12 months.
b. Installments are due in different years.
c. Ultimate amount collectible is indeterminate.
d. Percentage-of-completion method is inappropriate.

M91#10. Gibbs Co. uses the allowance method for recognizing uncollectible accounts. Ignoring deferred taxes, the entry to record the write-off of a specific uncollectible account

a. Affects **neither** net income **nor** working capital.
b. Affects **neither** net income **nor** accounts receivable.
c. Decreases both net income and accounts receivable.
d. Decreases both net income and working capital.

M91#21. Shep Co. has a receivable from its parent, Pep Co. Should this receivable be separately reported in Shep's balance sheet and in Pep's consolidated balance sheet?

	Shep's balance sheet	*Pep's consolidated balance sheet*
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

N89#6. On July 1, 1988, a company obtained a two-year 8% note receivable for services rendered. At that time the market rate of interest was 10%. The face amount of the note and the entire amount of the interest are due on June 30, 1990. Interest receivable at December 31, 1988, was

a. 5% of the face value of the note.
b. 4% of the face value of the note.
c. 5% of the July 1, 1988, present value of the amount due June 30, 1990.
d. 4% of the July 1, 1988, present value of the amount due June 30, 1990.

N89#7. A method of estimating uncollectible accounts that emphasizes asset valuation rather than income measurement is the allowance method based on

a. Aging the receivables.
b. Direct write off.
c. Gross sales.
d. Credit sales less returns and allowances.

M89#2. Which of the following is a method to generate cash from accounts receivable?

	Assignment	*Factoring*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M89#3. A note receivable bearing a reasonable interest rate is sold to a bank with recourse. At the date of the discounting transaction, the notes receivable discounted account should be

a. Decreased by the proceeds from the discounting transaction.
b. Increased by the proceeds from the discounting transaction.
c. Increased by the face amount of the note.
d. Decreased by the face amount of the note.

M88#7. A note receivable bearing a reasonable interest rate is sold to a bank with recourse. The notes receivable discounted account was appropriately credited. The notes receivable discounted account should be reported as a

a. Contra-asset account for the proceeds from the discounting transaction.
b. Contra-asset account for the face amount of the note.
c. Liability account for the proceeds from the discounting transaction.
d. Liability account for the face amount of the note.

C. Inventories

M92#23. Southgate Co. paid the in-transit insurance premium for consignment goods shipped to Hendon Co., the consignee. In addition, Southgate advanced part of the commissions that will be due when Hendon sells the goods. Should Southgate include the in-transit insurance premium and the advanced commissions in inventory costs?

	Insurance premium	*Advanced commissions*
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

M92#24. During periods of rising prices, when the FIFO inventory method is used, a perpetual inventory system results in an ending inventory cost that is

a. The same as in a periodic inventory system.
b. Higher than in a periodic inventory system.
c. Lower than in a periodic inventory system.
d. Higher or lower than in a periodic inventory system, depending on whether physical quantities have increased or decreased.

M92#25. Kahn Co., in applying the lower of cost or market method, reports its inventory at replacement cost. Which of the following statements are correct?

	The original cost is greater than replacement cost	*The net realizable value, less a normal profit margin, is greater than replacement cost*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N91#27. Thread Co. is selecting its inventory system in preparation for its first year of operations. Thread intends to use either the periodic weighted average method or the perpetual moving average method, and to apply the lower of cost or market rule either to individual items or to the total inventory. Inventory prices are expected to generally increase throughout 1991, although a few individual prices will decrease. What inventory system should Thread select if it wants to maximize the inventory carrying amount at December 31, 1991?

	Inventory method	*Cost or market application*
a.	Perpetual	Total inventory
b.	Perpetual	Individual item
c.	Periodic	Total inventory
d.	Periodic	Individual item

N91#28. When the double extension approach to the dollar value LIFO inventory method is used, the inventory layer added in the current year is multiplied by an index number. Which of the following correctly states how components are used in the calculation of this index number?

a. In the numerator, the average of the ending inventory at base year cost and at current year cost.
b. In the numerator, the ending inventory at current year cost, and, in the denominator, the ending inventory at base year cost.
c. In the numerator, the ending inventory at base year cost, and, in the denominator, the ending inventory at current year cost.
d. In the denominator, the average of the ending inventory at base year cost and at current year cost.

N90#15. How should the following costs affect a retailer's inventory?

	Freight in	*Interest on inventory loan*
a.	Increase	No effect
b.	Increase	Increase
c.	No effect	Increase
d.	No effect	No effect

N90#16. The retail inventory method includes which of the following in the calculation of both cost and retail amounts of goods available for sale?

a. Purchase returns.
b. Sales returns.
c. Net markups.
d. Freight in.

N90#17. The replacement cost of an inventory item is below the net realizable value and above the net realizable value less the normal profit margin. The original cost of the inventory item is below the net realizable value less the normal profit margin. Under the lower of cost or market method, the inventory item should be valued at

a. Net realizable value.
b. Net realizable value less the normal profit margin.
c. Original cost.
d. Replacement cost.

N89#8. Shipping costs incurred by a consignor on transfer of goods to a consignee should be considered as

a. Expense to the consignee.
b. Expense to the consignor.
c. Inventory cost to the consignee.
d. Inventory cost to the consignor.

N89#9. The UNO Company was formed on January 2, 1987, to sell a single product. Over a two-year period, UNO's acquisition costs have increased steadily. Physical quantities held in inventory were equal to three months' sales at December 31, 1987, and zero at December 31, 1988. Assuming the periodic inventory system, the inventory cost method which reports the highest amount for each of the following is

	Inventory December 31, 1987	*Cost of sales 1988*
a.	LIFO	FIFO
b.	LIFO	LIFO
c.	FIFO	FIFO
d.	FIFO	LIFO

N89#10. The original cost of an inventory item is above the replacement cost and the net realizable value. The replacement cost is below the net realizable value less the normal profit margin. As a result, under the lower of cost or market method, the inventory item should be reported at the

a. Net realizable value.
b. Net realizable value less the normal profit margin.
c. Replacement cost.
d. Original cost.

N88#6. According to the net method, which of the following items should be included in the cost of inventory?

	Freight costs	*Purchase discounts not taken*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#7. During periods of rising prices, a perpetual inventory system would result in the same dollar amount of ending inventory as a periodic inventory system under which of the following inventory cost flow methods?

	FIFO	*LIFO*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#8. Under the lower of cost or market method, the replacement cost of an inventory item would be used as the designated market value

a. When it is below the net realizable value less the normal profit margin.
b. When it is below the net realizable value and above the net realizable value less the normal profit margin.
c. When it is above the net realizable value.
d. Regardless of net realizable value.

D. Property, Plant, and Equipment Owned or Leased

M92#11. Derby Co. incurred costs to modify its building and to rearrange its production line. As a result, an overall reduction in production costs is expected. However, the modifications did not increase the building's market value, and the rearrangement did not extend the production line's life. Should the building modification costs and the production line rearrangement costs be capitalized?

	Building modification costs	*Production line rearrangement costs*
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

M92#12. Land was purchased to be used as the site for the construction of a plant. A building on the property was sold and removed by the buyer so that construction on the plant could begin. The proceeds from the sale of the building should be

a. Netted against the costs to clear the land and expensed as incurred.
b. Netted against the costs to clear the land and amortized over the life of the plant.
c. Deducted from the cost of the land.
d. Classified as other income.

M92#13. Lano Corp.'s forest land was condemned for use as a national park. Compensation for the condemnation exceeded the forest land's carrying amount. Lano purchased similar, but larger, replacement forest land for an amount greater than the condemnation award. As a result of the condemnation and replacement, what is the net effect on the carrying amount of forest land reported in Lano's balance sheet?

a. The amount is increased by the excess of the replacement forest land's cost over the condemned forest land's carrying amount.
b. The amount is increased by the excess of the replacement forest land's cost over the condemnation award.
c. The amount is increased by the excess of the condemnation award over the condemned forest land's carrying amount.
d. No effect, because the condemned forest land's carrying amount is used as the replacement forest land's carrying amount.

M92#16. A machine with a 5-year estimated useful life and an estimated 10% salvage value was acquired on January 1, 1988. On December 31, 1991, accumulated depreciation, using the sum-of-the-years' digits method, would be

a. (Original cost less salvage value) multiplied by $^{1}/_{15}$.
b. (Original cost less salvage value) multiplied by $^{14}/_{15}$.
c. Original cost multiplied by $^{14}/_{15}$.
d. Original cost multiplied by $^{1}/_{15}$.

N91#33. During January 1990, Vail Co. made long-term improvements to a recently leased building. The lease agreement provides for neither a transfer of title to Vail nor a bargain purchase option. The present value of the minimum lease payments equals 85% of the building's market value, and the lease term equals 70% of the building's economic life. Should assets be recognized for the building and the leasehold improvements?

	Building	*Leasehold improvements*
a.	Yes	Yes
b.	No	Yes
c.	Yes	No
d.	No	No

N90#13. A building suffered uninsured water and related damage. The damaged portion of the building was refurbished with upgraded materials. The cost and related accumulated depreciation of the damaged portion are identifiable. To account for these events, the owner should

a. Capitalize the cost of refurbishing and record a loss in the current period equal to the carrying amount of the damaged portion of the building.
b. Capitalize the cost of refurbishing by adding the cost to the carrying amount of the building.
c. Record a loss in the current period equal to the cost of refurbishing and continue to depreciate the original cost of the building.
d. Record a loss in the current period equal to the sum of the cost of refurbishing and the carrying amount of the damaged portion of the building.

M89#4. A depreciable asset has an estimated 15% salvage value. At the end of its estimated useful life, the accumulated depreciation would equal the original cost of the asset under which of the following depreciation methods?

	Straight-line	*Productive output*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M89#5. A lessee incurred costs to construct office space in a leased warehouse. The estimated useful life of the office is ten years. The remaining term of the nonrenewable lease is fifteen years. The costs should be

a. Capitalized as leasehold improvements and depreciated over fifteen years.
b. Capitalized as leasehold improvements and depreciated over ten years.
c. Capitalized as leasehold improvements and expensed in the year in which the lease expires.
d. Expensed as incurred.

M88#8. An expenditure to install an improved electrical system is a

	Capital expenditure	*Revenue expenditure*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M88#9. A company using the composite depreciation method for its fleet of trucks, cars, and campers retired one of its trucks and received cash from a salvage company. The net carrying amount of these composite asset accounts would be decreased by the

a. Cash proceeds received and original cost of the truck.
b. Cash proceeds received.
c. Original cost of the truck less the cash proceeds.
d. Original cost of the truck.

E. Intangibles and Other Assets

In February 1992, the FASB issued *Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes,* superseding *Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes.* Accordingly, future examinations will test knowledge of FASB No. 109.

M92#14. On December 31, 1990, Bit Co. had capitalized costs for a new computer software product with an economic life of five years. Sales for 1991 were 30 percent of expected total sales of the software. At December 31, 1991, the software had a net realizable value equal to 90 percent of the capitalized cost. What percentage of the original capitalized cost should be reported as the net amount on Bit's December 31, 1991, balance sheet?

a. 70%
b. 72%
c. 80%
d. 90%

N91#13. Say Co. purchased Ivy Co. at a cost that resulted in recognition of goodwill having an expected 10-year benefit period. However, Say plans to make additional expenditures to maintain goodwill for a total of 40 years. What costs should be capitalized and over how many years should they be amortized?

	Costs capitalized	*Amortization period*
a.	Acquisition costs only	10 years
b.	Acquisition costs only	40 years
c.	Acquisition and maintenance costs	10 years
d.	Acquisition and maintenance costs	40 years

M91#11. At the end of its first year of operations [December 31, 1990], Gold Co. reported a current deferred tax asset in accordance with FASB Statement No. 96, *Accounting for Income Taxes.* Will reversal of current temporary differences result in taxable or deductible amounts, and did Gold have a 1990 profit or loss for tax purposes?

	Taxable or deductible amounts	*Taxable status of 1990 operations*
a.	Taxable	Profit
b.	Taxable	Loss
c.	Deductible	Profit
d.	Deductible	Loss

N90#21. Effective January 1, 1989, Flood Co. established a defined benefit pension plan with no retroactive benefits. The first of the required equal annual contributions was paid on December 31, 1989. A 10% discount rate was used to calculate service cost and a 10% rate of return was assumed for plan assets. All information on covered employees for 1989 and 1990 is the same. How should the service cost for 1990 compare with 1989, and should the 1989 balance sheet report an accrued or a prepaid pension cost?

	Service cost for 1990 compared to 1989	*Pension cost reported on the 1989 balance sheet*
a.	Equal to	Accrued
b.	Equal to	Prepaid
c.	Greater than	Accrued
d.	Greater than	Prepaid

M90#6. The premium on a three-year insurance policy expiring on December 31, 1991 was paid in total on January 2, 1989. If the company has a six-month operating cycle, then on December 31, 1989, the prepaid insurance reported as a current asset would be for

a. 6 months.
b. 12 months.
c. 18 months.
d. 24 months.

N89#11. Which of the following costs associated with an internally developed patent should be capitalized?

	Research and development	*Patent registration*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N89#12. On December 31, 1987, the New Bite Company had capitalized costs for a new computer software product with an economic life of four years. Sales for 1988 were ten percent of expected total sales of the software. At December 31, 1988, the software had a net realizable value equal to eighty percent of the capitalized cost. The unamortized cost reported on the December 31, 1988, balance sheet should be

a. Net realizable value.
b. Ninety percent of net realizable value.
c. Seventy-five percent of capitalized cost.
d. Ninety percent of capitalized cost.

M89#6. Which of the following costs of goodwill should be capitalized and amortized?

	Developing goodwill	*Restoring goodwill*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#9. Which of the following legal fees should be capitalized?

	Legal fees to obtain a franchise	*Legal fees to successfully defend a trademark*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#10. Which of the following costs of goodwill should be capitalized and amortized over their estimated useful lives?

	Costs of goodwill from a business combination accounted for as a purchase	*Costs of developing goodwill internally*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals

M92#19. On October 1, 1991, Fleur Retailers signed a 4-month, 16% note payable to finance the purchase of holiday merchandise. At that date, there was no direct method of pricing the merchandise, and the note's market rate of interest was 11%. Fleur recorded the purchase at the note's face amount. All of the merchandise was sold by December 1, 1991. Fleur's 1991 financial statements reported interest payable and interest expense on the note for three months at 16%. All amounts due on the note were paid February 1, 1992.

As a result of Fleur's accounting treatment of the note, interest, and merchandise, which of the following items was reported correctly?

	12/31/91 retained earnings	*12/31/91 interest payable*
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

M92#26. On March 31, 1992, Dallas Co. received an advance payment of 60% of the sales price for special order goods to be manufactured and delivered within five months. At the same time, Dallas subcontracted for production of the special order goods at a price equal to 40% of the main contract price. What liabilities should be reported in Dallas' March 31, 1992, balance sheet?

	Deferred revenues	*Payables to subcontractor*
a.	None	None
b.	60% of main contract price	40% of main contract price
c.	60% of main contract price	None
d.	None	40% of main contract price

N91#31. An employer sponsoring a defined benefit pension plan is subject to the minimum pension liability recognition requirement. An additional liability must be recorded equal to the unfunded

a. Accumulated benefit obligation plus the previously recognized accrued pension cost.
b. Accumulated benefit obligation less the previously recognized accrued pension cost.
c. Projected benefit obligation plus the previously recognized accrued pension cost.
d. Projected benefit obligation less the previously recognized accrued pension cost.

M91#13. On May 1, 1990, Marno County issued property tax assessments for the fiscal year ended June 30, 1991. The first of two equal installments was due on November 1, 1990. On September 1, 1990, Dyur Co. purchased a 4-year old factory in Marno subject to an allowance for accrued taxes. Dyur did not record the entire year's property tax obligation, but instead records tax expenses at the end of each month by adjusting prepaid property taxes or property taxes payable, as appropriate. The recording of the November 1, 1990, payment by Dyur should have been allocated between an increase in prepaid property taxes and a decrease in property taxes payable in which of the following percentages?

	Percentage allocated to	
	Increase in prepaid property taxes	*Decrease in property taxes payable*
a.	66⅔%	33⅓%
b.	0%	100%
c.	50%	50%
d.	33⅓%	66⅔%

M91#14. At the end of 1989, Ritzcar Co. failed to accrue sales commissions earned during 1989 but paid in 1990. The error was not repeated in 1990. What was the effect of this error on 1989 ending working capital and on the 1990 ending retained earnings balance?

	1989 ending working capital	*1990 ending retained earnings*
a.	Overstated	Overstated
b.	No effect	Overstated
c.	No effect	No effect
d.	Overstated	No effect

N90#20. Mercer, Inc. maintains a defined benefit pension plan for its employees. As of December 31, 1989, the market value of the plan assets is less than the accumulated benefit obligation, and less than the projected benefit obligation. The projected benefit obligation exceeds the accumulated benefit obligation. In its balance sheet as of December 31, 1989, Mercer should report a minimum liability in the amount of the

a. Excess of the projected benefit obligation over the value of the plan assets.
b. Excess of the accumulated benefit obligation over the value of the plan assets.
c. Projected benefit obligation.
d. Accumulated benefit obligation.

N90#22. Which of the following is generally associated with payables classified as accounts payable?

	Periodic payment of interest	*Secured by collateral*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

M90#7. On December 31, 1989, special insurance costs, incurred but unpaid, were not recorded. If these insurance costs were related to work-in-process, what is the effect of the omission on accrued liabilities and retained earnings in the December 31, 1989 balance sheet?

	Accrued liabilities	*Retained earnings*
a.	No effect	No effect
b.	No effect	Overstated
c.	Understated	No effect
d.	Understated	Overstated

M90#8. A company issued a short-term note payable with a stated 12 percent rate of interest to a bank. The bank charged a .5% loan origination fee and remitted the balance to the company. The effective interest rate paid by the company in this transaction would be

a. Equal to 12.5%.
b. More than 12.5%.
c. Less than 12.5%.
d. Independent of 12.5%.

N89#13. A company receives an advance payment for special order goods that are to be manufactured and delivered within six months. The advance payment should be reported in the company's balance sheet as a

a. Deferred charge.
b. Contra asset account.
c. Current liability.
d. Noncurrent liability.

N88#10. At the end of the accounting period, which of the following costs should be accrued?

	Liability for federal unemployment taxes	*Wages earned but unpaid*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#11. On September 1, 1986, a company borrowed cash and signed a two-year interest-bearing note on which both the principal and interest are payable on September 1, 1988. How many months of accrued interest would be included in the liability for accrued interest at December 31, 1986, and December 31, 1987?

	At December 31, 1986	*At December 31, 1987*
a.	4 months	16 months
b.	4 months	4 months
c.	12 months	24 months
d.	20 months	8 months

B. Deferred Revenues

M92#32. Rig Co. sold its factory at a gain, and simultaneously leased it back for 10 years. The factory's remaining economic life is 20 years. The lease was reported as an operating lease. At the time of sale, Rig should report the gain as

a. An extraordinary item, net of income tax.
b. An asset valuation allowance.
c. A separate component of stockholders' equity.
d. A deferred credit.

N91#19. How would the proceeds received from the advance sale of nonrefundable tickets for a theatrical performance be reported in the seller's financial statements before the performance?

a. Revenue for the entire proceeds.
b. Revenue to the extent of related costs expended.
c. Unearned revenue to the extent of related costs expended.
d. Unearned revenue for the entire proceeds.

M91#15. An automobile dealer sells service contracts. The contracts stipulate that the dealer will perform specific repairs on covered vehicles. The contracts vary in length from 12 to 36 months. Do the following increase when service contracts are sold?

	Deferred revenue	*Service revenue*
a.	Yes	Yes
b.	No	No
c.	No	Yes
d.	Yes	No

N90#23. Jersey, Inc. is a retailer of home appliances and offers a service contract on each appliance sold. Jersey sells appliances on installment contracts, but all service contracts must be paid in full at the time of sale. Collections received for service contracts should be recorded as an increase in a

a. Deferred revenue account.
b. Sales contracts receivable valuation account.
c. Stockholders' valuation account.
d. Service revenue account.

N90#24. Able sold its headquarters building at a gain, and simultaneously leased back the building. The lease was reported as a capital lease. At the time of sale, the gain should be reported as

a. Operating income.
b. An extraordinary item, net of income tax.
c. A separate component of stockholders' equity.
d. An asset valuation allowance.

M90#9. A retail store received cash and issued gift certificates that are redeemable in merchandise. The gift certificates lapse one year after they are issued. How would the deferred revenue account be affected by each of the following transactions?

	Redemption of certificates	*Lapse of certificates*
a.	Decrease	No effect
b.	Decrease	Decrease
c.	No effect	No effect
d.	No effect	Decrease

N89#14. In a sale-leaseback transaction, the seller-lessee has retained the property. The gain on the sale should be recognized at the time of the sale-leaseback when the lease is classified as a(an)

	Capital lease	*Operating lease*
a.	Yes	Yes
b.	No	No
c.	No	Yes
d.	Yes	No

N88#11. According to the installment method of accounting, the gross profit on an installment sale is recognized in income

a. On the date of sale.
b. On the date the final cash collection is received.
c. After cash collections equal to the cost of sales have been received.
d. In proportion to the cash collections received.

M88#12. A retail store received cash and issued a gift certificate that is redeemable in merchandise. When the gift certificate was issued, a

a. Deferred revenue account should be decreased.
b. Deferred revenue account should be increased.
c. Revenue account should be decreased.
d. Revenue account should be increased.

C. Deferred Income Tax Liabilities

In February 1992, the FASB issued *Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes,* superseding *Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes.* Accordingly, future examinations will test knowledge of FASB No. 109.

M92#9. Orleans Co., a cash basis taxpayer, prepares accrual basis financial statements. Since 1988, Orleans has applied FASB Statement No. 96, *Accounting for Income Taxes.* In its 1991 balance sheet, Orleans' deferred income tax liabilities increased compared to 1990. Which of the following changes would cause this increase in deferred income tax liabilities?

I. An increase in prepaid insurance.
II. An increase in rent receivable.
III. An increase in warranty obligations.

a. I only.
b. I and II.
c. II and III.
d. III only.

N91#4. At the end of year 1, Cody Co. reported a profit on a partially completed construction contract by applying the percentage-of-completion method. By the end of year 2, the total estimated profit on the contract at completion in year 3 had been drastically reduced from the amount estimated at the end of year 1. Consequently, in year 2, a loss equal to one-half of the year 1 profit was recognized. Cody used the completed-contract method for income tax purposes and had no other contracts. According to FASB Statement No. 96, *Ac-*

counting for Income Taxes, the year 2 balance sheet should include a deferred tax

	Asset	*Liability*
a.	Yes	Yes
b.	No	Yes
c.	Yes	No
d.	No	No

N89#15. As a result of differences between depreciation for financial reporting purposes and tax purposes, the financial reporting basis of a company's plant assets exceeded the tax basis. Assuming the company had **no** other temporary differences, the company should report a

a. Current tax asset.
b. Current tax payable.
c. Deferred tax asset.
d. Deferred tax liability.

D. Capitalized Lease Liability

M92#33. For a capital lease, the amount recorded initially by the lessee as a liability should normally

a. Exceed the total of the minimum lease payments.
b. Exceed the present value of the minimum lease payments at the beginning of the lease.
c. Equal the total of the minimum lease payments.
d. Equal the present value of the minimum lease payments at the beginning of the lease.

N91#34. Jay's lease payments are made at the end of each period. Jay's liability for a capital lease would be reduced periodically by the

a. Minimum lease payment less the portion of the minimum lease payment allocable to interest.
b. Minimum lease payment plus the amortization of the related asset.
c. Minimum lease payment less the amortization of the related asset.
d. Minimum lease payment.

M90#11. A lessee had a ten-year capital lease requiring equal annual payments. The reduction of the lease liability in year 2 should equal

a. The current liability shown for the lease at the end of year 1.
b. The current liability shown for the lease at the end of year 2.
c. The reduction of the lease obligation in year 1.
d. One-tenth of the original lease liability.

N89#16. The present value of minimum lease payments should be used by the lessee in determining the amount of a lease liability under a lease classified by the lessee as a(an)

	Capital lease	*Operating lease*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#13. A six-year capital lease expiring on December 31 specifies equal minimum annual lease payments. Part of this payment represents interest and part represents a reduction in the net lease liability. The portion of the minimum lease payment in the fifth year applicable to the reduction of the net lease liability should be

a. Less than in the fourth year.
b. More than in the fourth year.
c. The same as in the sixth year.
d. More than in the sixth year.

E. Bonds Payable

N91#35. The market price of a bond issued at a discount is the present value of its principal amount at the market (effective) rate of interest

a. Less the present value of all future interest payments at the market (effective) rate of interest.
b. Less the present value of all future interest payments at the rate of interest stated on the bond.
c. Plus the present value of all future interest payments at the market (effective) rate of interest.
d. Plus the present value of all future interest payments at the rate of interest stated on the bond.

N91#37. Bonds with detachable stock warrants were issued by Flack Co. Immediately after issue the aggregate market value of the bonds and the warrants exceeds the proceeds. Is the portion of the proceeds allocated to the warrants less than their market value, and is that amount recorded as contributed capital?

	Less than warrants' market value	*Contributed capital*
a.	No	Yes
b.	Yes	No
c.	Yes	Yes
d.	No	No

M91#5. A 15-year bond was issued in 1980 at a discount. During 1990, a 10-year bond was issued at face amount with the proceeds used to retire the 15-year bond at its face amount. The net effect of the 1990 bond transactions was to increase long-term liabilities by the excess of the 10-year bond's face amount over the 15-year bond's

a. Face amount.
b. Carrying amount.
c. Face amount less the deferred loss on bond retirement.
d. Carrying amount less the deferred loss on bond retirement.

M91#6. On March 1, 1990, Clark Co. issued bonds at a discount. Clark incorrectly used the straight-line method instead of the effective interest method to amortize the discount. How were the following amounts, as of December 31, 1990, affected by the error?

	Bond carrying amount	*Retained earnings*
a.	Overstated	Overstated
b.	Understated	Understated
c.	Overstated	Understated
d.	Understated	Overstated

N90

Items 29 and 30 are based on the following:

On January 2, 1986, Chard Co. issued 10-year convertible bonds at 105. During 1989, these bonds were converted into common stock having an aggregate par value equal to the total face amount of the bonds. At conversion, the market price of Chard's common stock was 50 percent above its par value.

29. On January 2, 1986, cash proceeds from the issuance of the convertible bonds should be reported as

a. Contributed capital for the entire proceeds.
b. Contributed capital for the portion of the proceeds attributable to the conversion feature and as a liability for the balance.
c. A liability for the face amount of the bonds and contributed capital for the premium over the face amount.
d. A liability for the entire proceeds.

30. Depending on whether the book value method or the market value method was used, Chard would recognize gains or losses on conversion when using the

	Book value method	*Market value method*
a.	Either gain or loss	Gain
b.	Either gain or loss	Loss
c.	Neither gain **nor** loss	Loss
d.	Neither gain **nor** loss	Gain

N90#31. Main Co. issued bonds with detachable common stock warrants. Only the warrants had a known market value. The sum of the fair value of the warrants and the face amount of the bonds exceeds the cash proceeds. This excess is reported as

a. Discount on bonds payable.
b. Premium on bonds payable.
c. Common stock subscribed.
d. Contributed capital in excess of par-stock warrants.

N89#17. How would the carrying amount of a bond payable be affected by amortization of the following?

	Discount	*Premium*
a.	Increase	Increase
b.	Decrease	Decrease
c.	Increase	Decrease
d.	Decrease	Increase

N89#18. Bonds payable issued with scheduled maturities at various dates are called

	Serial bonds	*Term bonds*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N89#19. When bonds payable are converted into common stock, any gain or loss would be recognized when using the

	Book value method	*Market value method*
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

N88#14. The issue price of a bond is equal to the present value of the future cash flows for interest and principal when the bond is issued

	At par	*At a discount*	*At a premium*
a.	Yes	No	Yes
b.	Yes	No	No
c.	No	Yes	Yes
d.	Yes	Yes	Yes

N88#15. A company issued ten-year term bonds at a discount in 1986. Bond issue costs were incurred at that time. The company uses the effective interest method to amortize bond issue costs. Reporting the bond issue costs as a deferred charge would result in

a. More of a reduction in net income in 1987 than reporting the bond issue costs as a reduction of the related debt liability.
b. The same reduction in net income in 1987 as reporting the bond issue costs as a reduction of the related debt liability.

c. Less of a reduction in net income in 1987 than reporting the bond issue costs as a reduction of the related debt liability.
d. No reduction in net income in 1987.

N88#16. A ten-year term bond was issued in 1985 at a discount with a call provision to retire the bonds. When the bond issuer exercised the call provision on an interest date in 1987, the carrying amount of the bond was less than the call price. The amount of bond liability removed from the accounts in 1987 should have equaled the

a. Call price.
b. Call price less unamortized discount.
c. Face amount less unamortized discount.
d. Face amount plus unamortized discount.

M88#14. A five-year term bond was issued by a company on January 1, 1986, at a discount. The carrying amount of the bond at December 31, 1987, would be

a. Higher than the carrying amount at December 31, 1986.
b. Lower than the carrying amount at December 31, 1986.
c. The same as the carrying amount at January 1, 1986.
d. Higher than the carrying amount at December 31, 1988.

M88#15. At the time of conversion of bonds into common stock, the market value of the stock exceeds the net carrying amount of the bonds. A loss on conversion would be recognized when using the

	Book value method	*Market value method*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#16. When bonds are issued with stock purchase warrants, a portion of the proceeds should be allocated to paid-in capital for bonds issued with

	Detachable stock purchase warrants	*Nondetachable stock purchase warrants*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

F. Contingent Liabilities and Commitments

M92#27. Snelling Co. did not record an accrual for a contingent loss, but disclosed the nature of the contingency and the range of the possible loss. How likely is the loss?

a. Remote.
b. Reasonably possible.
c. Probable.
d. Certain.

M91#16. A manufacturer of household appliances may incur a loss due to the discovery of a defect in one of its products. The occurrence of the loss is reasonably possible and the resulting costs can be reasonably estimated. This possible loss should be

	Accrued	*Disclosed in footnotes*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N90#35. Wyatt Co. has a probable loss that can only be reasonably estimated within a range of outcomes. No single amount within the range is a better estimate than any other amount. The loss accrual should be

a. Zero.
b. The maximum of the range.
c. The mean of the range.
d. The minimum of the range.

M90#12. Management can estimate the amount of the loss that will occur if a foreign government expropriates some company assets. If expropriation is reasonably possible, a loss contingency should be

a. Neither accrued as a liability **nor** disclosed.
b. Accrued as a liability but **not** disclosed.
c. Disclosed and accrued as a liability.
d. Disclosed but **not** accrued as a liability.

M88#17. A lawsuit in connection with a safety hazard exists for a manufactured product. Occurrence of a loss is probable and the amount can be reasonably estimated. This loss contingency should be

	Accrued	*Disclosed in footnotes*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock

N91#40. Grid Corp. acquired some of its own common shares at a price greater than both their par value and original issue price but less than their book value. Grid uses the cost method of accounting for treasury stock. What is the impact of this acquisition on total stockholders' equity and the book value per common share?

	Total stockholders' equity	*Book value per share*
a.	Increase	Increase
b.	Increase	Decrease
c.	Decrease	Increase
d.	Decrease	Decrease

M90#13. The acquisition of treasury stock will cause the number of shares outstanding to decrease if the treasury stock is accounted for by the

	Cost method	*Par value method*
a.	Yes	No
b.	No	No
c.	Yes	Yes
d.	No	Yes

M89#8. The number of common stock shares outstanding would be decreased by the

	Declaration of a stock dividend	*Purchase of treasury stock*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N88#17. On December 1, 1987, shares of authorized common stock were issued on a subscription basis at a price in excess of par value. A total of 20% of the subscription price of each share was collected as a down payment on December 1, 1987, with the remaining 80% of the subscription price of each share due in 1988. Collectibility was reasonably assured. At December 31, 1987, the stockholders' equity section of the balance sheet would report additional paid-in capital for the excess of the subscription price over the par value of the shares of common stock subscribed and

a. Common stock issued for 20% of the par value of the shares of common stock subscribed.
b. Common stock issued for the par value of the shares of common stock subscribed.
c. Common stock subscribed for 80% of the par value of the shares of common stock subscribed.
d. Common stock subscribed for the par value of the shares of common stock subscribed.

B. Additional Paid-in Capital

N89#20. A corporation was organized in January 1988 with authorized capital of $10 par value common stock. On February 1, 1988, shares were issued at par for cash. On March 1, 1988, the corporation's attorney accepted 5,000 shares of the common stock in settlement for legal services with a fair value of $60,000. Additional paid-in capital would increase on

	February 1, 1988	*March 1, 1988*
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

C. Retained Earnings and Dividends

M92#37. A retained earnings appropriation can be used to

a. Absorb a fire loss when a company is self-insured.
b. Provide for a contingent loss that is probable and reasonable.
c. Smooth periodic income.
d. Restrict earnings available for dividends.

N91#25. In single period statements, which of the following should be reflected as an adjustment to the opening balance of retained earnings?

a. Effect of a failure to provide for uncollectible accounts in the previous period.
b. Effect of a decrease in the estimated useful life of depreciable equipment.
c. Cumulative effect of a change of income recognition from the installment sale method to recognition at point of sale.
d. Cumulative effect of a change from an accelerated method to straight-line depreciation.

M91#17. A company declared a cash dividend on its common stock on December 15, 1990, payable on January 12, 1991. How would this dividend affect stockholders' equity on the following dates?

	December 15, 1990	*December 31, 1990*	*January 12, 1991*
a.	Decrease	No effect	Decrease
b.	Decrease	No effect	No effect
c.	No effect	Decrease	No effect
d.	No effect	No effect	Decrease

N90#32. How would the declaration of a 15% stock dividend by a corporation affect each of the following?

	Retained earnings	*Total stockholders' equity*
a.	No effect	No effect
b.	No effect	Decrease
c.	Decrease	No effect
d.	Decrease	Decrease

N90#36. Which of the following should be reported as a prior period adjustment?

	Change in estimated lives of depreciable assets	*Change from unaccepted principle to accepted principle*
a.	Yes	Yes
b.	No	Yes
c.	Yes	No
d.	No	No

M90#14. Pott Co. owned shares in Rose Co. On December 1, 1989, Pott declared and distributed a property dividend of Rose shares when their fair value exceeded the carrying amount. As a consequence of the dividend declaration and distribution, the accounting effects would be

	Property dividends recorded at	*Retained earnings*
a.	Fair value	Decreased
b.	Fair value	Increased
c.	Cost	Increased
d.	Cost	Decreased

N89#21. A corporation declared a dividend, a portion of which was liquidating. How would this declaration affect each of the following?

	Additional paid-in capital	*Retained earnings*
a.	Decrease	No effect
b.	Decrease	Decrease
c.	No effect	Decrease
d.	No effect	No effect

N88#18. How would a stock split in which the par value per share decreases in proportion to the number of additional shares issued affect each of the following?

	Additional paid-in capital	*Retained earnings*
a.	Increase	No effect
b.	No effect	No effect
c.	No effect	Decrease
d.	Increase	Decrease

M88#19. A property dividend should be recorded in retained earnings at the property's

a. Book value at date of declaration.
b. Book value at date of issuance (payment).
c. Market value at date of declaration.
d. Market value at date of issuance (payment).

D. Treasury Stock and Other Contra Accounts

M92#38. The functional currency of Nash, Inc.'s subsidiary is the French franc. Nash borrowed French francs as a partial hedge of its investment in the subsidiary. In preparing consolidated financial statements, Nash's translation loss on its investment in the subsidiary exceeded its exchange gain on the borrowing. How should the effects of the loss and gain be reported in Nash's consolidated financial statements?

a. The translation loss less the exchange gain is reported separately in the stockholders' equity section of the balance sheet.
b. The translation loss less the exchange gain is reported in the income statement.
c. The translation loss is reported separately in the stockholders' equity section of the balance sheet and the exchange gain is reported in the income statement.
d. The translation loss is reported in the income statement and the exchange gain is reported separately in the stockholders' equity section of the balance sheet.

N91#39. Posy Corp. acquired treasury shares at an amount greater than their par value, but less than their original issue price. Compared to the cost method of accounting for treasury stock, does the par value method report a greater amount for additional paid-in capital and a greater amount for retained earnings?

	Additional paid-in capital	*Retained earnings*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M91#18. On incorporation, Dee Inc. issued common stock at a price in excess of its par value. No other stock transactions occurred except treasury stock was acquired for an amount exceeding this issue price. If Dee uses the par value method of accounting for treasury stock appropriate for retired stock, what is the effect of the acquisition on the following?

	Net common stock	*Additional paid-in capital*	*Retained earnings*
a.	No effect	Decrease	No effect
b.	Decrease	Decrease	Decrease
c.	Decrease	No effect	Decrease
d.	No effect	Decrease	Decrease

N90#33. At its date of incorporation, Glean, Inc. issued 100,000 shares of its $10 par common stock at $11 per share. During the current year, Glean acquired 30,000 shares of its common stock at a price of $16 per share and accounted for them by the cost method. Subsequently, these shares were reissued at a price of $12 per share. There have been no other issuances or acquisitions of its own common stock. What effect does the reissuance of the stock have on the following accounts?

	Retained earnings	*Additional paid-in capital*
a.	Decrease	Decrease
b.	No effect	Decrease
c.	Decrease	No effect
d.	No effect	No effect

M90#15. Treasury stock was acquired for cash at a price in excess of its original issue price. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the par value method of accounting for treasury stock transactions is used, what is the effect on total stockholders' equity of each of the following events?

	Acquisition of treasury stock	*Reissuance of treasury stock*
a.	Decrease	No effect
b.	Decrease	Increase
c.	Increase	Decrease
d.	No effect	No effect

N89#22. Ten thousand shares of $10 par value common stock were issued initially at $15 per share. Subsequently, one thousand of these shares were purchased as treasury stock at $13 per share. The cost method of accounting for treasury stock is used. What is the effect of the purchase of the treasury stock on the amount reported in the balance sheet on each of the following?

	Additional paid-in capital	*Total stockholders' equity*
a.	No effect	No effect
b.	No effect	Decrease
c.	Decrease	No effect
d.	Decrease	Decrease

M89#10. The par-value method of accounting for treasury stock differs from the cost method in that

a. Any gain is recognized upon repurchase of stock but a loss is treated as an adjustment to retained earnings.
b. No gains or losses are recognized on the issuance of treasury stock using the par-value method.
c. It reverses the original entry to issue the common stock with any difference between carrying value and purchase price adjusted through paid-in capital and/or retained earnings and treats a subsequent reissuance like a new issuance of common stock.
d, It reverses the original entry to issue the common stock with any difference between carrying value and purchase price being shown as an ordinary gain or loss and does **not** recognize any gain or loss on a subsequent resale of the stock.

N88#19. Treasury stock was acquired for cash at a price in excess of its par value. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect of the subsequent reissuance of the treasury stock on each of the following?

	Additional paid-in capital	*Retained earnings*	*Total stockholders' equity*
a.	Decrease	Decrease	No effect
b.	Increase	Increase	Increase
c.	Increase	No effect	Increase
d.	No effect	No effect	No effect

E. Stock Options, Warrants, and Rights

N91#38. Tem Co. issued rights to its existing stockholders without consideration. A stockholder received a right to buy one share for each 20 shares held. The exercise price was in excess of par value, but less than the current market price. Retained earnings decreases when

	Rights are issued	*Rights are exercised*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M91#19. Cricket Corp. issued, without consideration, rights allowing stockholders to subscribe for additional shares at an amount greater than par value but less than both market and book values. When the rights are exercised, how are the following accounts affected?

	Retained earnings	*Additional paid-in capital*
a.	Decreased	Not affected
b.	Not affected	Not affected
c.	Decreased	Increased
d.	Not affected	Increased

M90#16. Blue Co. issued preferred stock with detachable common stock warrants at a price which exceeded both the par value and the market value of the preferred stock. At the time the warrants are exercised, Blue's total stockholders' equity is increased by the

	Cash received upon exercise of the warrants	*Carrying amount of warrants*
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

N89#23. A corporation issued rights to its existing stockholders to purchase unissued shares of $10 par value common stock for $25 per share. The rights were issued for no consideration. Additional paid-in capital will be credited when the rights are

	Issued	*Exercised*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M89#11. A company issued rights to its existing shareholders without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. When the rights are issued, which of the following will be increased?

	Common stock	*Additional paid-in capital*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#20. A company issued rights to its existing shareholders. The rights were issued without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. Common stock will be increased when the

	Rights are issued	*Rights lapse*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M88#21. A company issued rights to its existing shareholders. The rights were issued without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. Additional paid-in capital will be

a. Increased when the rights are exercised.
b. Increased when the rights are issued.
c. Decreased when the rights are exercised.
d. Decreased when the rights expire.

G. Partnerships

M92#35. In the Adel-Brick partnership, Adel and Brick had a capital ratio of 3:1 and a profit and loss ratio of 2:1, respectively. The bonus method was used to record Colter's admittance as a new partner. What ratio would be used to allocate, to Adel and Brick, the excess of Colter's contribution over the amount credited to Colter's capital account?

a. Adel and Brick's new relative capital ratio.
b. Adel and Brick's new relative profit and loss ratio.
c. Adel and Brick's old capital ratio.
d. Adel and Brick's old profit and loss ratio.

N91#15. The Flat and Iron partnership agreement provides for Flat to receive a 20% bonus on profits before the bonus. Remaining profits and losses are divided between Flat and Iron in the ratio of 2 to 3, respectively. Which partner has a greater advantage when the partnership has a profit or when it has a loss?

	Profit	*Loss*
a.	Flat	Iron
b.	Flat	Flat
c.	Iron	Flat
d.	Iron	Iron

M91#39. Four individuals who were previously sole proprietors form a partnership. Each partner contributes inventory and equipment for use by the partnership. What basis should the partnership use to record the contributed assets?

a. Inventory at the lower of FIFO cost or market.
b. Inventory at the lower of weighted average cost or market.
c. Equipment at each proprietor's carrying amount.
d. Equipment at fair value.

N90#40. Hayes and Jenkins formed a partnership, each contributing assets to the business. Hayes contributed inventory with a current market value in excess of its carrying amount. Jenkins contributed real estate with a carrying amount in excess of its current market value. At what amount should the partnership record each of the following assets?

	Inventory	*Real estate*
a.	Market value	Market value
b.	Market value	Carrying amount
c.	Carrying amount	Market value
d.	Carrying amount	Carrying amount

M90#17. Allen retired from the partnership of Allen, Beck and Chale. Allen's cash settlement from the partnership was based on new goodwill determined at the date of retirement plus the carrying amount of the other net assets. As a consequence of the settlement, the capital accounts of Beck and Chale were decreased. In accounting for Allen's withdrawal, the partnership could have used the

	Bonus method	*Goodwill method*
a.	No	Yes
b.	No	No
c.	Yes	Yes
d.	Yes	No

N89#24. On July 1, 1988, a partnership was formed by Johnson and Smith. Johnson contributed cash. Smith, previously a sole proprietor, contributed property other than cash including realty subject to a mortgage, which was assumed by the partnership. Smith's capital account at July 1, 1988, should be recorded at

a. Smith's book value of the property at July 1, 1988.
b. Smith's book value of the property less the mortgage payable at July 1, 1988.
c. The fair value of the property less the mortgage payable at July 1, 1988.
d. The fair value of the property at July 1, 1988.

M89#12. The Low and Rhu partnership agreement provides special compensation to Low for managing the business. Low receives a bonus of 15 percent of partnership net income before salary and bonus, and also receives a salary of $45,000. Any remaining profit or loss is to be allocated equally. During 1988, the partnership had net income of $50,000 before the bonus and salary allowance. As a result of these distributions, Rhu's equity in the partnership would

a. Increase.
b. Not change.
c. Decrease the same as Low's.
d. Decrease.

N88#21. The partnership of Metcalf, Petersen, and Russell shared profits and losses equally. When Metcalf withdrew from the partnership, the partners agreed that there was unrecorded goodwill in the partnership. Under the bonus method, the capital balances of Petersen and Russell were

a. Not affected.
b. Each reduced by one half of the total amount of the unrecorded goodwill.
c. Each reduced by one third of the total amount of the unrecorded goodwill.
d. Each reduced by one half of Metcalf's share of the total amount of the unrecorded goodwill.

M88#22. A partnership is formed by two individuals who were previously sole proprietors. Which of the following parts of the initial investment in the newly created partnership would be recorded at the fair value at the date of the investment?

	Marketable securities	*Inventories*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

A. Revenues and Gains

M92#6. Before 1991, Droit Co. used the cash basis of accounting. As of December 31, 1991, Droit changed to the accrual basis. Droit cannot determine the beginning balance of supplies inventory. What is the effect of Droit's inability to determine beginning supplies inventory on its 1991 accrual basis net income and December 31, 1991, accrual basis owners' equity?

	1991 net income	*12/31/91 owners' equity*
a.	No effect	No effect
b.	No effect	Overstated
c.	Overstated	No effect
d.	Overstated	Overstated

M92#39. A foreign subsidiary's functional currency is its local currency, which has not experienced significant inflation. The weighted average exchange rate for the current year would be the appropriate exchange rate for translating

	Sales to customers	*Wages expense*
a.	No	No
b.	Yes	Yes
c.	No	Yes
d.	Yes	No

M92#43. For the last 10 years, Woody Co. has owned cumulative preferred stock issued by Hadley, Inc. During 1991, Hadley declared and paid both the 1991 dividend and the 1990 dividend in arrears. How should Woody report the 1990 dividend in arrears that was received in 1991?

a. As a reduction in cumulative preferred dividends receivable.
b. As a retroactive change of the prior period financial statements.
c. Include, net of income taxes, after 1991 income from continuing operations.
d. Include in 1991 income from continuing operations.

M92#44. A company uses the completed-contract method to account for a long-term construction contract. Revenue is recognized when recorded progress billings

	Are collected	*Exceed recorded costs*
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

M92#45. Income recognized using the installment method of accounting generally equals cash collected multiplied by the

a. Net operating profit percentage.
b. Net operating profit percentage adjusted for expected uncollectible accounts.
c. Gross profit percentage.
d. Gross profit percentage adjusted for expected uncollectible accounts.

M92#46. Under a royalty agreement with another enterprise, a company will receive royalties from the assignment of a patent for three years. The royalties received should be reported as revenue

a. At the date of the royalty agreement.
b. In the period earned.
c. In the period received.
d. Evenly over the life of the royalty agreement.

N91#5. During 1990, Tidal Co. began construction on a project scheduled for completion in 1992. At December 31, 1990, an overall loss was anticipated at contract completion. What would be the effect of the project on 1990 operating income under the percentage-of-completion method and the completed-contract method?

	Percentage-of-completion	*Completed-contract*
a.	No effect	No effect
b.	No effect	Decrease
c.	Decrease	No effect
d.	Decrease	Decrease

N91#10. An investor uses the cost method to account for an investment in common stock. Dividends received this year exceeded the investor's share of investee's undistributed earnings since the date of investment. The amount of dividend revenue that should be reported in the investor's income statement for this year would be

a. The portion of the dividends received this year that were in excess of the investor's share of investee's undistributed earnings since the date of investment.
b. The portion of the dividends received this year that were **not** in excess of the investor's share of investee's undistributed earnings since the date of investment.
c. The total amount of dividends received this year.
d. Zero.

N91#14. When the equity method is used to account for investments in common stock, which of the following affects the investor's reported investment income?

	Goodwill amortization related to purchase	*Cash dividends from investee*
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

N91#20. Dee's inventory and accounts payable balances at December 31, 1990, increased over their December 31, 1989, balances. Should these increases be added to or deducted from cash payments to suppliers to arrive at 1990 cost of goods sold?

	Increase in inventory	*Increase in accounts payable*
a.	Added to	Deducted from
b.	Added to	Added to
c.	Deducted from	Deducted from
d.	Deducted from	Added to

M91#8. Drew Co. produces expensive equipment for sale on installment contracts. When there is doubt about eventual collectibility, the income recognition method **least** likely to overstate income is

a. At the time the equipment is completed.
b. The installment method.
c. The cost recovery method.
d. At the time of delivery.

M91#9. Bee Co. uses the direct write-off method to account for uncollectible accounts receivable. During an accounting period, Bee's cash collections from customers equal sales adjusted for the addition or deduction of the following amounts:

	Accounts written-off	*Increase in accounts receivable balance*
a.	Deduction	Deduction
b.	Addition	Deduction
c.	Deduction	Addition
d.	Addition	Addition

M91#20. Park Co. uses the equity method to account for its January 1, 1990, purchase of Tun Inc.'s common stock. On January 1, 1990, the fair values of Tun's FIFO inventory and land exceeded their carrying amounts. How do these excesses of fair values over carrying amounts affect Park's reported equity in Tun's 1990 earnings?

	Inventory excess	*Land excess*
a.	Decrease	Decrease
b.	Decrease	No effect
c.	Increase	Increase
d.	Increase	No effect

M91#22. For a marketable equity securities portfolio included in noncurrent assets, which of the following amounts should be included in the period's net income?

I. Unrealized temporary losses during the period.
II. Realized gains during the period.
III. Changes in the valuation allowance during the period.

a. III only.
b. II only.
c. I and II.
d. I, II, and III.

M91#28. Tay Co. uses the percentage-of-completion method to account for a five-year construction contract. Third year progress billings collected in the fourth year would

a. Be included in the calculation of third year income.
b. Be included in the calculation of third year income in so far as they exceeded second year billings collected in the third year.
c. Be included in the calculation of fourth year income.
d. Not be included in the calculation of third, fourth, or fifth year incomes.

N90#26. In a lease that is recorded as a sales-type lease by the lessor, interest revenue

a. Should be recognized in full as revenue at the lease's inception.
b. Should be recognized over the period of the lease using the straight-line method.
c. Should be recognized over the period of the lease using the effective interest method.
d. Does **not** arise.

N90#37. Gown, Inc. sold a warehouse and used the proceeds to acquire a new warehouse. The excess of the proceeds over the carrying amount of the warehouse sold should be reported as a(an)

a. Extraordinary gain, net of income taxes.
b. Part of continuing operations.
c. Gain from discontinued operations, net of income taxes.
d. Reduction of the cost of the new warehouse.

N90#39. Gains from remeasuring a foreign subsidiary's financial statements from the local currency, which is not the functional currency, into the parent company's currency should be reported as a(an)

a. Deferred foreign exchange gain.
b. Separate component of stockholders' equity.
c. Extraordinary item, net of income taxes.
d. Part of continuing operations.

M90#18. Compared to the accrual basis of accounting, the cash basis of accounting overstates income by the net increase during the accounting period of the

	Accounts receivable	*Accrued expenses payable*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

M90#20. A fixed asset with a five-year estimated useful life and no residual value is sold at the end of the second year of its useful life. How would using the sum-of-the-years'-digits method of depreciation instead of the double declining balance method of depreciation affect a gain or loss on the sale of the fixed asset?

	Gain	*Loss*
a.	Decrease	Decrease
b.	Decrease	Increase
c.	Increase	Decrease
d.	Increase	Increase

N89#25. Which of the following would be used in the calculation of the income recognized in the fourth and final year of a contract accounted for by the percentage-of-completion method?

	Actual total costs	*Income previously recognized*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M89#13. A company uses the completed-contract method to account for a four-year construction contract which is presently in its third year. Progress billings were recorded and collected in the third year. Based on events occurring in the third year, there is now an anticipated loss on the contract. When would the effect of each of the following be reported in the company's income statement?

	Third year progress billings	*Anticipated loss*
a.	Not third year	Third year
b.	Not third year	Fourth year
c.	Third year	Third year
d.	Third year	Fourth year

M89#14. According to the cost recovery method of accounting, gross profit on an installment sale is recognized in income

a. After cash collections equal to the cost of sales have been received.
b. In proportion to the cash collections.
c. On the date the final cash collection is received.
d. On the date of sale.

M89#15. An investor uses the equity method to account for an investment in common stock. The investor's equity in the earnings of the investee would be affected by

	Cash dividends from investee	*A change in market value of the investee's common stock*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M89#16. Under a royalty agreement with another enterprise, a company will receive royalties from the assignment of a patent for four years. The royalties received in advance should be reported as revenue

a. In the period received.
b. In the period earned.
c. Evenly over the life of the royalty agreement.
d. At the date of the royalty agreement.

N88#22. A company uses the percentage-of-completion method to account for a four-year construction contract. Which of the following would be used in the calculation of the income recognized in the first year?

	Progress billings	*Collections on progress billings*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#24. Rent should be reported by the lessor as revenue over the lease term as it becomes receivable according to the provisions of the lease for a

	Direct-financing lease	*Operating lease*	*Sales-type lease*
a.	Yes	Yes	Yes
b.	Yes	No	No
c.	No	Yes	No
d.	No	No	Yes

N88#25. A December 15, 1987, purchase of goods was denominated in a currency other than the entity's functional currency. The transaction resulted in a payable that was fixed in terms of the amount of foreign currency, and was paid on the settlement date, January 20, 1988. The exchange rates between the functional currency and the currency in which the transaction was denominated changed between the transaction date and December 31, 1987, and again between December 31, 1987, and January 20, 1988. Both exchange rate changes resulted in gains. The amount of the gain that should be included in the 1988 financial statements would be

a. The gain from December 31, 1987, to January 20, 1988.
b. The gain from December 15, 1987, to January 20, 1988.
c. The gain from December 15, 1987, to December 31, 1987.
d. Zero.

M88#23. A company uses the completed-contract method to account for a long-term construction contract. Revenue is recognized when progress billings are

	Recorded	*Collected*
a.	No	Yes
b.	Yes	Yes
c.	Yes	No
d.	No	No

B. Expenses and Losses

M92#15. What factor must be present to use the units-of-production (activity) method of depreciation?

a. Total units to be produced can be estimated.
b. Production is constant over the life of the asset.
c. Repair costs increase with use.
d. Obsolescence is expected.

M92#17. On January 1, 1991, Brecon Co. installed cabinets to display its merchandise in customers' stores. Brecon expects to use these cabinets for five years. Brecon's 1991 multi-step income statement should include

a. One-fifth of the cabinet costs in cost of goods sold.
b. One-fifth of the cabinet costs in selling, general, and administrative expenses.
c. All of the cabinet costs in cost of goods sold.
d. All of the cabinet costs in selling, general, and administrative expenses.

M92#18. On October 1, 1991, Fleur Retailers signed a 4-month, 16% note payable to finance the purchase of holiday merchandise. At that date, there was no direct method of pricing the merchandise, and the note's market rate of interest was 11%. Fleur recorded the purchase at the note's face amount. All of the merchandise was sold by December 1, 1991. Fleur's 1991 financial statements reported interest payable and interest expense on the note for three months at 16%. All amounts due on the note were paid February 1, 1992.

Fleur's 1991 cost of goods sold for the holiday merchandise was

a. Overstated by the difference between the note's face amount and the note's October 1, 1991, present value.
b. Overstated by the difference between the note's face amount and the note's October 1, 1991, present value plus 11% interest for two months.
c. Understated by the difference between the note's face amount and the note's October 1, 1991, present value.
d. Understated by the difference between the note's face amount and the note's October 1, 1991, present value plus 16% interest for two months.

M92#20. Interest cost included in the net pension cost recognized by an employer sponsoring a defined benefit pension plan represents the

a. Amortization of the discount on unrecognized prior service costs.
b. Increase in the fair value of plan assets due to the passage of time.
c. Increase in the projected benefit obligation due to the passage of time.
d. Shortage between the expected and actual returns on plan assets.

M92#22. A bond issued on June 1, 1991, has interest payment dates of April 1 and October 1. Bond interest expense for the year ended December 31, 1991, is for a period of

a. Seven months.
b. Six months.
c. Four months.
d. Three months.

M92#29. The effect of a transaction that is infrequent in occurrence but **not** unusual in nature should be presented separately as a component of income from continuing operations when the transaction results in a

	Loss	*Gain*
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

M92#31. Which of the following costs is included in research and development expense?

a. Ongoing efforts to improve existing products.
b. Troubleshooting in connection with breakdowns during commercial production.
c. Periodic design changes to existing products.
d. Design, construction, and testing of preproduction prototypes and models.

M92#34. On January 1, 1991, Mollat Co. signed a 7-year lease for equipment having a 10-year economic life. The present value of the monthly lease payments equaled 80% of the equipment's fair value. The lease agreement provides for neither a transfer of title to Mollat nor a bargain purchase option. In its 1991 income statement Mollat should report

a. Rent expense equal to the 1991 lease payments.
b. Rent expense equal to the 1991 lease payments less interest expense.
c. Lease amortization equal to one-tenth of the equipment's fair value.
d. Lease amortization equal to one-seventh of 80% of the equipment's fair value.

M92#36. Instead of the usual cash dividend, Evie Corp. declared and distributed a property dividend from its overstocked merchandise. The excess of the merchandise's carrying amount over its market value should be

a. Ignored.
b. Reported as a separately disclosed reduction of retained earnings.
c. Reported as an extraordinary loss, net of income taxes.
d. Reported as a reduction in income before extraordinary items.

N91#18. Shore Co. records its transactions in U.S. dollars. A sale of goods resulted in a receivable denominated in Japanese yen, and a purchase of goods resulted in a payable denominated in French francs. Shore recorded a foreign exchange gain on collection of the receivable and an exchange loss on settlement of the payable. The exchange rates are expressed as so many units of foreign currency to one dollar. Did the number of foreign currency units exchangeable for a dollar increase or decrease between the contract and settlement dates?

	Yen exchangeable for $1	*Francs exchangeable for $1*
a.	Increase	Increase
b.	Decrease	Decrease
c.	Decrease	Increase
d.	Increase	Decrease

N91#29. Compensatory stock options were granted to executives on May 1, 1988, with a measurement date of October 31, 1989, for services rendered during 1988, 1989, and 1990. The excess of the market value of the stock over the option price at the measurement date was reasonably estimable at the date of grant. The stock options were exercised on June 30, 1991. Compensation expense should be recognized in which of the following years?

	1988	*1990*
a.	Yes	No
b.	No	No
c.	Yes	Yes
d.	No	Yes

N91#32. On January 1, 1990, Jambon purchased equipment for use in developing a new product. Jambon uses the straight-line depreciation method. The equipment could provide benefits over a 10-year period. However, the new product development is expected to take five years, and the equipment can be used only for this project. Jambon's 1990 expense equals

a. The total cost of the equipment.
b. One-fifth of the cost of the equipment.
c. One-tenth of the cost of the equipment.
d. Zero.

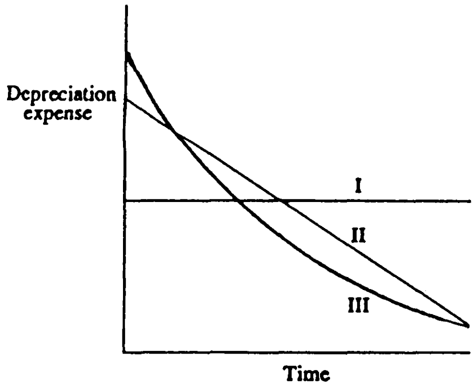
M91#23. During 1990, Bay Co. constructed machinery for its own use and for sale to customers. Bank loans financed these assets both during construction and after construction was complete. How much of the interest incurred should be reported as interest expense in the 1990 income statement?

	Interest incurred for machinery for own use	*Interest incurred for machinery held for sale*
a.	All interest incurred	All interest incurred
b.	All interest incurred	Interest incurred after completion
c.	Interest incurred after completion	Interest incurred after completion
d.	Interest incurred after completion	All interest incurred

M91#25. A transaction that is unusual, but **not** infrequent, should be reported separately as a(an)

a. Extraordinary item, net of applicable income taxes.
b. Extraordinary item, but **not** net of applicable income taxes.
c. Component of income from continuing operations, net of applicable income taxes.
d. Component of income from continuing operations, but **not** net of applicable income taxes.

N90#14. The graph below depicts three depreciation expense patterns over time.



Which depreciation expense pattern corresponds to the sum-of-the-years'-digits method and which corresponds to the double-declining-balance method?

	Sum-of-the-years'-digits	*Double-declining balance*
a.	III	II
b.	II	I
c.	I	III
d.	II	III

N90#19. Under the allowance method of recognizing uncollectible accounts, the entry to write-off an uncollectible account

a. Increases the allowance for uncollectible accounts.
b. Has **no** effect on the allowance for uncollectible accounts.
c. Has **no** effect on net income.
d. Decreases net income.

M90#21. Net income is understated if, in the first year, estimated salvage value is excluded from the depreciation computation when using the

	Straight-line method	*Production or use method*
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

M90#22. A balance arising from the translation or remeasurement of a subsidiary's foreign currency financial statements is reported in the consolidated income statement when the subsidiary's functional currency is the

	Foreign currency	*U.S. dollar*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

M90#24. A twenty-year property lease, classified as an operating lease, provides for a 10% increase in annual payments every five years. In the sixth year compared to the fifth year, the lease will cause the following expenses to increase

	Rent	*Interest*
a.	No	Yes
b.	Yes	No
c.	Yes	Yes
d.	No	No

M89#17. A machine with a four-year estimated useful life and an estimated 10% salvage value was acquired on January 1, 1986. The depreciation expense for 1988 using the double-declining-balance method would be original cost multiplied by

a. 90% × 50% × 50% × 50%.
b. 50% × 50% × 50%.
c. 90% × 50% × 50%.
d. 50% × 50%.

M89#18. A sale of goods was denominated in a currency other than the entity's functional currency. The sale resulted in a receivable that was fixed in terms of the amount of foreign currency that would be received. The exchange rate between the functional currency and the currency in which the transaction was denominated changed. The effect of the change should be included as a

a. Separate component of stockholders' equity whether the change results in a gain or a loss.
b. Separate component of stockholders' equity if the change results in a gain, and as a component of income if the change results in a loss.
c. Component of income if the change results in a gain, and as a separate component of stockholders' equity if the change results in a loss.
d. Component of income whether the change results in a gain or a loss.

M89#19. A company uses the allowance method to recognize uncollectible accounts expense. What is the effect at the time of the collection of an account previously written off on each of the following accounts?

	Allowance for uncollectible accounts	*Uncollectible accounts expense*
a.	No effect	Decrease
b.	Increase	Decrease
c.	Increase	No effect
d.	No effect	No effect

M89#20. Which of the following components should be included in net pension cost by an employer sponsoring a defined benefit pension plan?

	Amortization of unrecognized prior service cost	*Fair value of plan assets*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M89#21. The effect of a material transaction that is unusual in nature but **not** infrequent in occurrence should be presented separately as a component of income from continuing operations when the transaction results in a

	Gain	*Loss*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#26. In a periodic inventory system that uses the weighted average cost flow method, the beginning inventory is the

a. Net purchases minus the ending inventory.
b. Net purchases minus the cost of goods sold.
c. Total goods available for sale minus the net purchases.
d. Total goods available for sale minus the cost of goods sold.

N88#27. A research and development activity for which the cost would be expensed as incurred is

a. Engineering follow-through in an early phase of commercial production.
b. Design, construction, and testing of preproduction prototypes and models.
c. Trouble-shooting in connection with breakdowns during commercial production.
d. Periodic design changes to existing products.

N88#28. A company received royalties from the assignment of patents to other enterprises. In the period in which the royalties are earned, the royalties should be

a. Subtracted from the capitalizable cost of the patent.
b. Amortized to income over the remaining useful life of the patent.
c. Netted against patent amortization expense.
d. Reported as revenue.

N88#29. Which of the following components should be included in the calculation of net pension cost recognized for a period by an employer sponsoring a defined benefit pension plan?

	Interest cost	*Actual return on plan assets*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#25. Depreciation is computed on the original cost less estimated salvage value under which of the following depreciation methods?

	Double-declining balance	*Productive output*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#26. A sale of goods was denominated in a currency other than the entity's functional currency. The sale resulted in a receivable that was fixed in terms of the amount of foreign currency that would be received. Exchange rates between the functional currency and the currency in which the transaction was denominated changed so that a loss was incurred. This loss should be included as a

a. Translation loss reported as a component of income from continuing operations.
b. Translation loss reported as a separate component of stockholders' equity.
c. Transaction loss reported as a component of income from continuing operations.
d. Transaction loss reported as a separate component of stockholders' equity.

C. Provision for Income Tax

In February 1992, the FASB issued *Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes,* superseding *Statement of Financial Accounting Standards No. 96, Accounting for Income Taxes.* Accordingly, future examinations will test knowledge of FASB No. 109.

M92#10. According to FASB Statement No. 96, *Accounting for Income Taxes,* which of the following items should affect current income tax expense for 1991?

a. Interest on a 1989 tax deficiency paid in 1991.
b. Penalty on a 1989 tax deficiency paid in 1991.
c. Change in income tax rate for 1991.
d. Change in income tax rate for 1992.

N91#3. According to FASB Statement No. 96, *Accounting for Income Taxes,* justification for the method of determining periodic deferred tax expense is based on the concept of

a. Matching of periodic expense to periodic revenue.
b. Objectivity in the calculation of periodic expense.
c. Recognition of assets and liabilities.
d. Consistency of tax expense measurements with actual tax planning strategies.

N89#27. Temporary differences arise when expenses are deductible for tax purposes

	After they are recognized in financial income	*Before they are recognized in financial income*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M89#22. Temporary differences arise when revenues are taxable

	After they are recognized in financial income	*Before they are recognized in financial income*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

D. Recurring Versus Nonrecurring Transactions and Events

M92#30. In open market transactions, Oak Corp. simultaneously sold its long-term investment in Maple Corp. bonds and purchased its own outstanding bonds. The broker remitted the net cash from the two transactions. Oak's gain on the purchase of its own bonds exceeded its loss on the sale of Maple's bonds. Oak should report the

a. Net effect of the two transactions as an extraordinary gain.
b. Net effect of the two transactions in income before extraordinary items.
c. Effect of its own bond transaction gain in income before extraordinary items, and report the Maple bond transaction as an extraordinary loss.
d. Effect of its own bond transaction as an extraordinary gain, and report the Maple bond transaction loss in income before extraordinary items.

N91#23. In 1990, Teller Co. incurred losses arising from its guilty plea in its first antitrust action, and from a substantial increase in production costs caused when a major supplier's workers went on strike. Which of these losses should be reported as an extraordinary item?

	Antitrust action	*Production costs*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

M91#26. Gains or losses from the early extinguishment of debt, if material, should be

a. Recognized in income before taxes in the period of extinguishment.
b. Recognized as an extraordinary item in the period of extinguishment.
c. Amortized over the life of the new issue.
d. Amortized over the remaining original life of the extinguished issue.

N90#38. Whetstone Co. took advantage of market conditions to refund debt. This was the fourth refunding operation carried out by Whetstone within the last three years. The excess of the carrying amount of the old debt over the amount paid to extinguish it should be reported as a(an)

a. Extraordinary gain, net of income taxes.
b. Extraordinary loss, net of income taxes.
c. Part of continuing operations.
d. Deferred credit to be amortized over life of new debt.

M90#26. On September 30, 1989, a commitment was made to dispose of a business segment in early 1990. The segment operating loss for the period October 1 to December 31, 1989, should be included in the 1989 income statement as part of

a. Loss on disposal of the discontinued segment.
b. Operating loss of the discontinued segment.
c. Income or loss from continuing operations.
d. Extraordinary gains or losses.

M89#23. An extraordinary item should be reported separately on the income statement as a component of income

	Before discontinued operations of a segment of a business	*Net of income taxes*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N88#31. When a segment of a business has been discontinued during the year, the loss on disposal should

a. Exclude operating losses of the current period up to the measurement date.
b. Exclude operating losses during the phase-out period.
c. Be an extraordinary item.
d. Be an operating item.

M88#28. A gain or loss from a transaction that is unusual in nature and infrequent in occurrence should be reported separately as a component of income

a. Before cumulative effect of accounting changes and after discontinued operations of a segment of a business.
b. After cumulative effect of accounting changes and after discontinued operations of a segment of a business.
c. Before cumulative effect of accounting changes and before discontinued operations of a segment of a business.
d. After cumulative effect of accounting changes and before discontinued operations of a segment of a business.

E. Accounting Changes

N91#26. In 1990, Brighton Co. changed from the individual item approach to the aggregate approach in applying the lower of FIFO cost or market to inventories. The cumulative effect of this change should be reported in Brighton's financial statements as a

a. Prior period adjustment, with separate disclosure.
b. Component of income from continuing operations, with separate disclosure.
c. Component of income from continuing operations, without separate disclosure.
d. Component of income after continuing operations, with separate disclosure.

M91#34. Is the cumulative effect of an inventory pricing change on prior years earnings reported separately between extraordinary items and net income for a change from

	LIFO to weighted average?	*FIFO to weighted average?*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M89#24. The cumulative effect of changing to a new accounting principle should be recorded separately as a component of income after continuing operations for a change from the

a. Straight-line method of depreciation for previously recorded assets to the sum-of-the-years'-digits method.
b. LIFO method of inventory pricing to the FIFO method.
c. Percentage-of-completion method of accounting for long-term construction-type contracts to the completed-contract method.
d. Cash basis of accounting for vacation pay to the accrual basis.

N88#32. The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of

	Future periods	*The period of change*
a.	No	No
b.	Yes	No
c.	Yes	Yes
d.	No	Yes

F. Earnings Per Share

N91#16. Earnings per share data should be reported on the income statement for

	Cumulative effect of a change in accounting principle	Income before extraordinary items
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M91#29. In determining earnings per share, interest expense, net of applicable income taxes, on convertible debt that is both a common stock equivalent and dilutive should be

a. Added back to net income for primary earnings per share, and ignored for fully diluted earnings per share.
b. Added back to net income for both primary earnings per share and fully diluted earnings per share.
c. Deducted from net income for primary earnings per share, and ignored for fully diluted earnings per share.
d. Deducted from net income for both primary earnings per share and fully diluted earnings per share.

N90#34. When computing fully diluted earnings per share, convertible securities that are **not** common stock equivalents are

a. Ignored.
b. Recognized only if they are dilutive.
c. Recognized only if they are anti-dilutive.
d. Recognized whether they are dilutive or anti-dilutive.

M90#29. An antidilutive common stock option is

	A common stock equivalent	Included in computing primary earnings per share
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

N89#28. A company's convertible debt is both a common stock equivalent and dilutive in determining earnings per share. What would be the effect of consideration of the convertible debt in calculating

	Primary earnings per share	Fully diluted earnings per share
a.	Decrease	Decrease
b.	Increase	No effect
c.	No effect	Decrease
d.	Decrease	Increase

M89#25. Antidilutive stock options would generally be used in the calculation of

	Primary earnings per share	Fully diluted earnings per share
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#33. Dilutive stock options would generally be used in the calculation of

	Primary earnings per share	Fully diluted earnings per share
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

VI. Other Financial Topics

A. Statement of Cash Flows

M92#7. In a statement of cash flows, which of the following would increase reported cash flows from operating activities using the direct method? (Ignore income tax considerations.)
a. Dividends received from investments.
b. Gain on sale of equipment.
c. Gain on early retirement of bonds.
d. Change from straight-line to accelerated depreciation.

M92#8. Which of the following cash flows per share should be reported in a statement of cash flows?
a. Primary cash flows per share only.
b. Fully diluted cash flows per share only.
c. Both primary and fully diluted cash flows per share.
d. Cash flows per share should **not** be reported.

N91#21. Would the following be added back to net income when reporting operating activities' cash flows by the indirect method?

	Excess of treasury stock acquisition cost over sales proceeds (cost method)	*Bond discount amortization*
a.	Yes	Yes
b.	No	No
c.	No	Yes
d.	Yes	No

N91#22. Bay Manufacturing Co. purchased a three-month U.S. Treasury bill. In preparing Bay's statement of cash flows, this purchase would
a. Have **no** effect.
b. Be treated as an outflow from financing activities.
c. Be treated as an outflow from investing activities.
d. Be treated as an outflow from lending activities.

M91#30. In a statement of cash flows, if used equipment is sold at a loss, the amount shown as a cash inflow from investing activities equals the carrying amount of the equipment
a. Less the loss and plus the amount of tax attributable to the loss.
b. Less both the loss and the amount of tax attributable to the loss.
c. Less the loss.
d. With **no** addition or subtraction.

M91#31. In a statement of cash flows, which of the following items is reported as a cash outflow from financing activities?

I. Payments to retire mortgage notes.
II. Interest payments on mortgage notes.
III. Dividend payments.
a. I, II, and III.
b. II and III.
c. I only.
d. I and III.

M90
Items 27 and 28 are based on the following:

A company acquired a building, paying a portion of the purchase price in cash and issuing a mortgage note payable to the seller for the balance.

27. In a statement of cash flows, what amount is included in investing activities for the above transaction?
a. Cash payment.
b. Acquisition price.
c. Zero.
d. Mortgage amount.

28. In a statement of cash flows, what amount is included in financing activities for the above transaction?
a. Cash payment.
b. Acquisition price.
c. Zero.
d. Mortgage amount.

N89#29. In a statement of cash flows, proceeds from issuing equity instruments should be classified as cash inflows from
a. Lending activities.
b. Operating activities.
c. Investing activities.
d. Financing activities.

N89#30. In a statement of cash flows, payments to acquire debt instruments of other entities (other than cash equivalents) should be classified as cash outflows for
a. Operating activities.
b. Investing activities.
c. Financing activities.
d. Lending activities.

M89#26. In a statement of cash flows, receipts from sales of property, plant, and equipment and other productive assets should generally be classified as cash inflows from
a. Operating activities.
b. Financing activities.
c. Investing activities.
d. Selling activities.

M89#27. In a statement of cash flows, interest payments to lenders and other creditors should be classified as cash outflows for

a. Operating activities.
b. Borrowing activities.
c. Lending activities.
d. Financing activities.

B. Accounting Policies

M91#32. The summary of significant accounting policies should disclose the

a. Pro forma effect of retroactive application of an accounting change.
b. Basis of profit recognition on long-term construction contracts.
c. Adequacy of pension plan assets in relation to vested benefits.
d. Future minimum lease payments in the aggregate and for each of the five succeeding fiscal years.

M90#30. Which of the following facts concerning fixed assets should be included in the summary of significant accounting policies?

	Depreciation method	*Composition*
a.	No	Yes
b.	Yes	Yes
c.	Yes	No
d.	No	No

M89#28. Which of the following should be disclosed in the summary of significant accounting policies?

	Composition of inventories	*Maturity dates of long-term debt*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M88#32. Which of the following should be disclosed in the summary of significant accounting policies?

	Composition of plant assets	*Inventory pricing*
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

C. Accounting Changes

M92#40. Matt Co. included a foreign subsidiary in its 1991 consolidated financial statements. The subsidiary was acquired in 1985 and was excluded from previous consolidations. The change was caused by the elimination of foreign exchange controls. Including the subsidiary in the 1991 consolidated financial statements results in an accounting change that should be reported

a. By footnote disclosure only.
b. Currently and prospectively.
c. Currently with footnote disclosure of pro forma effects of retroactive application.
d. By restating the financial statements of all prior periods presented.

N91#24. The effect of a change in accounting principle that is inseparable from the effect of a change in accounting estimate should be reported

a. By restating the financial statements of all prior periods presented.
b. As a correction of an error.
c. As a component of income from continuing operations, in the period of change and future periods if the change affects both.
d. As a separate disclosure after income from continuing operations, in the period of change and future periods if the change affects both.

M91#27. When a company changes the expected service life of an asset because additional information has been obtained, which of the following should be reported?

	Pro forma effects of retroactive application	*Cumulative effect of a change in accounting principle*
a.	Yes	Yes
b.	No	Yes
c.	Yes	No
d.	No	No

M89#29. A change in the periods benefitted by a deferred cost because additional information has been obtained is

a. A correction of an error.
b. An accounting change that should be reported by restating the financial statements of all prior periods presented.
c. An accounting change that should be reported in the period of change and future periods if the change affects both.
d. Not an accounting change.

D. Nonmonetary Transactions

M91#35. May Co. and Sty Co. exchanged nonmonetary assets. The exchange did not culminate an earning process for either May or Sty. May paid cash to Sty in connection with the exchange. To the extent that the amount of cash exceeds a proportionate share of the carrying amount of the asset surrendered, a realized gain on the exchange should be recognized by

	May	*Sty*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N90#12. Solen Co. and Nolse Co. exchanged similar trucks with fair values in excess of carrying amounts. In addition, Solen paid Nolse to compensate for the difference in truck values. As a consequence of the exchange, Solen recognizes

a. A gain equal to the difference between the fair value and carrying amount of the truck given up.
b. A gain determined by the proportion of cash paid to the total consideration.
c. A loss determined by the proportion of cash paid to the total consideration.
d. Neither a gain **nor** a loss.

M90#31. Scott Co. exchanged similar nonmonetary assets with Dale Co. No cash was exchanged. The carrying amount of the asset surrendered by Scott exceeded both the fair value of the asset received and Dale's carrying amount of that asset. Scott should recognize the difference between the carrying amount of the asset it surrendered and

a. The fair value of the asset it received as a loss.
b. The fair value of the asset it received as a gain.
c. Dale's carrying amount of the asset it received as a loss.
d. Dale's carrying amount of the asset it received as a gain.

N89#34. An investment in marketable securities was accounted for by the cost method. These securities were distributed to stockholders as a property dividend in a nonreciprocal transfer. The dividend should be reported at the

a. Fair value of the asset transferred or the recorded amount of the asset transferred, whichever is higher.
b. Fair value of the asset transferred or the recorded amount of the asset transferred, whichever is lower.
c. Fair value of the asset transferred.
d. Recorded amount of the asset transferred.

N88#36. An entity disposes of a nonmonetary asset in a nonreciprocal transfer. A gain or loss should be recognized on the disposition of the asset when the fair value of the asset transferred is determinable and the nonreciprocal transfer is to

	Another entity	*A stockholder of the entity*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

E. Business Combinations

N91#11. Cedar Co.'s planned combination with Birch Co. on January 1, 1992, can be structured as either a purchase or a pooling of interests. In a purchase, Cedar would acquire Birch's identifiable net assets for less than their book values. These book values approximate fair values. Birch's assets consist of current assets and depreciable noncurrent assets. How would the combined entity's 1992 net income and operating cash flows under purchase accounting compare to those under pooling of interests accounting? Ignore costs required to effect the combination and income tax expense.

	Purchase accounting net income	*Purchase accounting operating cash flows*
a.	Equal to pooling	Greater than pooling
b.	Equal to pooling	Equal to pooling
c.	Greater than pooling	Greater than pooling
d.	Greater than pooling	Equal to pooling

N91#12. A business combination is accounted for as a pooling of interests. Costs of furnishing information to stockholders related to effecting the business combination should be

a. Deducted directly from retained earnings of the combined corporation.
b. Deducted in determining net income of the combined corporation for the period in which the costs were incurred.
c. Capitalized but **not** amortized.
d. Capitalized and subsequently amortized over a period **not** exceeding forty years.

N90#4. Company J acquired all of the outstanding common stock of Company K in exchange for cash. The acquisition price exceeds the fair value of net assets acquired. How should Company J determine the amounts to be reported for the plant and equipment and long-term debt acquired from Company K?

	Plant and equipment	*Long-term debt*
a.	K's carrying amount	K's carrying amount
b.	K's carrying amount	Fair value
c.	Fair value	K's carrying amount
d.	Fair value	Fair value

N90#5. A business combination is accounted for as a pooling of interests. In the consolidated balance sheet, the following component(s) of stockholders' equity may be less than the sum of those same components of the merging companies

	Retained earnings	*Contributed capital*
a.	No	No
b.	Yes	No
c.	No	Yes
d.	Yes	Yes

M90#32. In order to report a business combination as a pooling of interests, the minimum amount of an investee's common stock that must be acquired during

the combination period in exchange for the investor's common stock is
a. 51 percent.
b. 80 percent.
c. 90 percent.
d. 100 percent.

M90#33. In a business combination accounted for as a purchase, the appraisal value of the identifiable assets acquired exceeds the acquisition price. The excess appraisal value should be reported as a
a. Deferred credit.
b. Reduction of the values assigned to current assets and a deferred credit for any unallocated portion.
c. Reduction of the values assigned to noncurrent assets and a deferred credit for any unallocated portion.
d. Pro rata reduction of the values assigned to current and noncurrent assets.

N89#32. A business combination is accounted for properly as a pooling of interests. Which of the following expenses related to effecting the business combination should enter into the determination of net income of the combined corporation for the period in which the expenses are incurred?

	Fees of finders and consultants	*Registration fees*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N89#33. A supportive argument for the pooling of interests method of accounting for a business combination is that
a. One company is clearly the dominant and continuing entity.
b. Goodwill is generally a part of any acquisition.
c. A portion of the total cost is assigned to individual assets acquired on the basis of their fair value.
d. It was developed within the boundaries of the historical-cost system and is compatible with it.

M89#30. A business combination is accounted for appropriately as a pooling of interests. Registration fees related to effecting the business combination should be
a. Deducted directly from retained earnings of the combined corporation.
b. Deducted in determining net income of the combined corporation for the period in which the costs were incurred.
c. Capitalized and subsequently amortized over a period **not** exceeding forty years.
d. Capitalized but **not** subsequently amortized.

M89#31. A business combination is accounted for appropriately as a purchase. Which of the following should be deducted in determining the combined corporation's net income for the current period?

	Direct costs of acquisition	*General expenses related to acquisition*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

F. Interim Financial Statements

N91#2. For interim financial reporting, a company's income tax provision for the second quarter of 1991 should be determined using the
a. Statutory tax rate for 1991.
b. Effective tax rate expected to be applicable for the second quarter of 1991.
c. Effective tax rate expected to be applicable for the full year of 1991 as estimated at the end of the first quarter of 1991.
d. Effective tax rate expected to be applicable for the full year of 1991 as estimated at the end of the second quarter of 1991.

M91#36. A planned volume variance in the first quarter, which is expected to be absorbed by the end of the fiscal period, ordinarily should be deferred at the end of the first quarter if it is

	Favorable	*Unfavorable*
a.	Yes	No
b.	No	Yes
c.	No	No
d.	Yes	Yes

N90#7. For interim financial reporting, an extraordinary gain occurring in the second quarter should be
a. Recognized ratably over the last three quarters.
b. Recognized ratably over all four quarters with the first quarter being restated.
c. Recognized in the second quarter.
d. Disclosed by footnote only in the second quarter.

M90#34. Advertising costs may be accrued or deferred to provide an appropriate expense in each period for

	Interim financial reporting	*Year-end financial reporting*
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

N89#35. For interim financial reporting, the computation of a company's second quarter provision for income taxes uses an effective tax rate expected to be applicable for the full fiscal year. The effective tax rate should reflect anticipated

	Foreign tax rates	*Available tax planning alternatives*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M89#32. An inventory loss from a market price decline occurred in the first quarter. The loss was not expected to be restored in the fiscal year. However, in the third quarter the inventory had a market price recovery that exceeded the market decline that occurred in the first quarter. For interim financial reporting, the dollar amount of net inventory should

a. Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of the market price recovery.
b. Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of decrease in the first quarter.
c. Not be affected in the first quarter and increase in the third quarter by the amount of the market price recovery that exceeded the amount of the market price decline.
d. Not be affected in either the first quarter or the third quarter.

N88#37. For interim financial reporting, which of the following may be accrued or deferred to provide an appropriate cost in each period?

	Interest	*Rent*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

G. Gain Contingencies

M92#28. At December 31, 1991, Creole Co. was suing a competitor for patent infringement. The award from the probable favorable outcome could be reasonably estimated. Creole's 1991 financial statements should report the expected award as a

a. Receivable and revenue.
b. Receivable and reduction of patent.
c. Receivable and deferred revenue.
d. Disclosure by footnote only.

M90#35. Grim Corporation operates a plant in a foreign country. It is probable that the plant will be expropriated. However, the foreign government has indicated that Grim will receive a definite amount of compensation for the plant. The amount of compensation is less than the fair market value but exceeds the carrying amount of the plant. The contingency should be reported

a. As a valuation allowance as a part of stockholders' equity.
b. As a fixed asset valuation allowance account.
c. In the notes to the financial statements.
d. In the income statement.

M89#33. When the occurrence of a gain contingency is reasonably possible and its amount can be reasonably estimated, the gain contingency should be

a. Included in net income and disclosed.
b. Included as an appropriation of retained earnings.
c. Disclosed, but **not** included in net income.
d. Neither included in net income nor disclosed.

H. Segments and Lines of Business

M91#33. In financial reporting of segment data, which of the following would be used to determine a segment's operating income?

a. Gain or loss on discontinued operations.
b. General corporate expense.
c. Sales to other segments.
d. Income tax expense.

M90#36. YIV Inc. is a multidivisional corporation which has both intersegment sales and sales to unaffiliated customers. YIV should report segment financial information for each division meeting which of the following criteria?

a. Segment operating profit or loss is 10% or more of consolidated profit or loss.
b. Segment operating profit or loss is 10% or more of combined operating profit or loss of all company segments.
c. Segment revenue is 10% or more of combined revenue of all the company segments.
d. Segment revenue is 10% or more of consolidated revenue.

N89#36. In financial reporting for segments of a business enterprise, the operating profit or loss of a manufacturing segment includes

	Interest expense	*Portion of general corporate expense*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M89#34. In financial reporting for segments of a business enterprise, which of the following should be taken into account in computing the amount of an industry segment's identifiable assets?

	Accumulated depreciation	*Marketable securities valuation allowance*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#37. In financial reporting for segments of a business enterprise, the revenue of a segment should include

a. Intersegment billings for the cost of shared facilities.
b. Intersegment sales of services similar to those sold to unaffiliated customers.
c. Equity in income from unconsolidated subsidiaries.
d. Extraordinary items.

I. Employee Benefits

N91#30. Which of the following defined benefit pension plan disclosures should be made in a company's financial statements?

I. A description of the company's funding policies and types of assets held.
II. The amount of net periodic pension cost for the period.
III. The fair value of plan assets.

a. I and II.
b. I, II, and III.
c. II and III.
d. I only.

M91#37. For a defined benefit pension plan, the discount rate used to calculate the projected benefit obligation is determined by the

	Expected return on plan assets	*Actual return on plan assets*
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

M90#37. Barrett Co. maintains a defined benefit pension plan for its employees. At each balance sheet date, Barrett should report a minimum liability at least equal to the

a. Accumulated benefit obligation.
b. Projected benefit obligation.
c. Unfunded accumulated benefit obligation.
d. Unfunded projected benefit obligation.

M89#35. An employer sponsoring a defined benefit pension plan should disclose the

	Amount of unrecognized prior service cost	*Projected benefit obligation*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M89#36. An employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered. The payment of compensation is probable and the amount of compensation can be reasonably estimated. Employees' compensation should be

a. Accrued if the obligation relates to rights that vest or accumulate.
b. Accrued if the obligation relates to rights that do **not** vest or accumulate.
c. Expensed when paid.
d. Disclosed, but **not** accrued if the obligation relates to rights that vest or accumulate.

N88#38. If the payment of employees' compensation for future absences is probable, the amount can be reasonably estimated, and the obligation relates to rights that vest, the compensation should be

a. Recognized when paid.
b. Accrued if attributable to employees' services whether already rendered or **not**.
c. Accrued if attributable to employees' services already rendered.
d. Accrued if attributable to employees' services **not** already rendered.

J. Analysis of Financial Statements

M92#48. On December 31, 1991, Northpark Co. collected a receivable due from a major customer. Which of the following ratios would be increased by this transaction?

a. Inventory turnover ratio.
b. Receivable turnover ratio.
c. Current ratio.
d. Quick ratio.

N91#17. Successful use of leverage is evidenced by a

a. Rate of return on investment greater than the rate of return on stockholders' equity.
b. Rate of return on investment greater than the cost of debt.
c. Rate of return on sales greater than the rate of return on stockholders' equity.
d. Rate of return on sales greater than the cost of debt.

M91#38. At December 30, 1990, Solomon Co. had a current ratio greater than 1:1 and a quick ratio less than

1:1. On December 31, 1990, all cash was used to reduce accounts payable. How did these cash payments affect the ratios?

	Current ratio	*Quick ratio*
a.	Decreased	Decreased
b.	Decreased	Increased
c.	Increased	Decreased
d.	Increased	Increased

N90#10. Are the following ratios useful in assessing the liquidity position of a company?

	Defensive-interval ratio	*Return on stockholders' equity*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M90#38. How is the average inventory used in the calculation of each of the following?

	Acid test (quick) ratio	*Inventory turnover rate*
a.	Numerator	Numerator
b.	Numerator	Denominator
c.	Not used	Denominator
d.	Not used	Numerator

M89#37. Which of the following ratios is(are) useful in assessing a company's ability to meet currently maturing or short-term obligations?

	Acid-test ratio	*Debt to equity ratio*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N88#39. Which of the following ratios help users to assess the company's ability to meet currently maturing or short-term obligations?

	Dividend payout ratio	*Acid-test ratio*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M88#38. Which of the following ratios are useful for evaluating the effectiveness with which the company uses its assets?

	Acid test (quick) ratio	*Price earnings ratio*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

K. Development Stage Enterprises

M92#49. Financial reporting by a development stage enterprise differs from financial reporting for an established operating enterprise in regard to footnote disclosures

a. Only.
b. And expense recognition principles only.
c. And revenue recognition principles only.
d. And revenue and expense recognition principles.

N90#8. Deficits accumulated during the development stage of a company should be

a. Reported as organization costs.
b. Reported as a part of stockholders' equity.
c. Capitalized and written off in the first year of principal operations.
d. Capitalized and amortized over a five year period beginning when principal operations commence.

M90#39. ABC Co. was organized on July 15, 1987, and earned no significant revenues until the first quarter of 1990. During the period 1987–89, ABC acquired plant and equipment, raised capital, obtained financing, trained employees, and developed markets. In its financial statements as of December 31, 1989, ABC should defer all costs incurred during 1987–89,

a. Net of revenues earned, which are recoverable in future periods.
b. Net of revenues earned.
c. Which are recoverable in future periods.
d. Without regard to net revenues earned or recoverability in future periods.

N89#38. A development stage enterprise should use the same generally accepted accounting principles that apply to established operating enterprises for

	Deferral of costs	*Expensing of costs when incurred*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M89#38. A development stage enterprise

a. Issues an income statement that shows only cumulative amounts from the enterprise's inception.
b. Issues an income statement that is the same as an established operating enterprise, but does **not** show cumulative amounts from the enterprise's inception as additional information.
c. Issues an income statement that is the same as an established operating enterprise, and shows cumulative amounts from the enterprise's inception as additional information.
d. Does **not** issue an income statement.

M88#39. A development stage enterprise should use the same generally accepted accounting principles that apply to established operating enterprises for

	Capitalization of costs	*Recognition of revenue*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

L. Personal Financial Statements

M92#50. In personal financial statements, how should estimated income taxes on the excess of the estimated current values of assets over their tax bases be reported in the statement of financial condition?

a. As liabilities.
b. As deductions from the related assets.
c. Between liabilities and net worth.
d. In a footnote disclosure only.

M91#40. Personal financial statements should report an investment in life insurance at the

a. Face amount of the policy less the amount of premiums paid.
b. Cash value of the policy less the amount of any loans against it.
c. Cash value of the policy less the amount of premiums paid.
d. Face amount of the policy less the amount of any loans against it.

N90#9. Personal financial statements should report assets and liabilities at

a. Historical cost.
b. Historical cost and, as additional information, at estimated current values at the date of the financial statements.
c. Estimated current values at the date of the financial statements.
d. Estimated current values at the date of the financial statements and, as additional information, at historical cost.

M90#40. A business interest that constitutes a large part of an individual's total assets should be presented in a personal statement of financial condition as

a. A single amount equal to the proprietorship equity.
b. A single amount equal to the estimated current value of the business interest.
c. A separate listing of the individual assets and liabilities, at cost.
d. Separate line items of both total assets and total liabilities, at cost.

N89#39. Personal financial statements should include which of the following statements?

	Financial condition	*Changes in net worth*	*Cash flows*
a.	No	Yes	Yes
b.	Yes	No	No
c.	Yes	Yes	No
d.	Yes	Yes	Yes

M89#39. In a personal statement of financial condition, which of the following should be reported at estimated current values?

	Investments in closely held businesses	*Investments in leaseholds*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#40. In a personal statement of financial condition, which of the following should be reported at quoted market prices?

	Marketable debt securities	*Marketable equity securities*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#40. Personal financial statements should report an investment in life insurance in the statement of financial condition as an

a. Asset for the cash value of the policy less the amount of any loans against it.
b. Asset for the cash value of the policy and a liability for the amount of any loans against it.
c. Asset for the face amount of the policy less the amount of any loans against it.
d. Asset for the face amount of the policy less the amount of premiums paid.

M. Combined Financial Statements

N91#8. For which of the following reporting units is the preparation of combined financial statements most appropriate?

a. A corporation and a majority-owned subsidiary with nonhomogeneous operations.
b. A corporation and a foreign subsidiary with nonintegrated homogeneous operations.
c. Several corporations with related operations with some common individual owners.
d. Several corporations with related operations owned by one individual.

N90#3. Combined statements may be used to present the results of operations of

	Unconsolidated subsidiaries	*Companies under common management*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N89#40. Which of the following items should be treated in the same manner in both combined financial statements and consolidated statements?

	Different fiscal periods	*Foreign operations*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M89#40. Which of the following items should be treated in the same manner in both combined financial statements and consolidated statements?

	Income taxes	*Minority interest*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

N91#41. In a job cost system, manufacturing overhead is

	An indirect cost of jobs	*A necessary element in production*
a.	No	Yes
b.	No	No
c.	Yes	Yes
d.	Yes	No

M91#46. In developing a predetermined factory overhead application rate for use in a process costing system, which of the following could be used in the numerator and denominator?

	Numerator	*Denominator*
a.	Actual factory overhead.	Actual machine hours.
b.	Actual factory overhead.	Estimated machine hours.
c.	Estimated factory overhead.	Actual machine hours.
d.	Estimated factory overhead.	Estimated machine hours.

N90#41. Wages earned by machine operators in producing the firm's product should be categorized as

	Direct labor	*Controllable by the machine operators' foreman*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M90#41. Indirect labor is a
a. Prime cost.
b. Conversion cost.
c. Period cost.
d. Nonmanufacturing cost.

N89#41. Direct labor cost is a

	Conversion cost	*Prime cost*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M89#41. Direct materials cost is a

	Conversion cost	*Prime cost*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N88#41. The fixed portion of the semivariable cost of electricity for a manufacturing plant is a

	Period cost	*Product cost*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#41. An example of a direct labor cost is wages paid to a

	Factory machine operator	*Supervisor in a factory*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

B. Process and Job Order Costing

M92#51. In a process cost system, the application of factory overhead usually would be recorded as an increase in

a. Finished goods inventory control.
b. Factory overhead control.
c. Cost of goods sold.
d. Work-in-process inventory control.

N91#43. A direct labor overtime premium should be charged to a specific job when the overtime is caused by the

a. Increased overall level of activity.
b. Customer's requirement for early completion of job.
c. Management's failure to include the job in the production schedule.
d. Management's requirement that the job be completed before the annual factory vacation closure.

M91#42. A process costing system was used for a department that began operations in January 1991. Approximately the same number of physical units, at the same degree of completion, were in work in process at the end of both January and February. Monthly conversion costs are allocated between ending work in process and units completed. Compared to the FIFO method, would the weighted average method use the same or a greater number of equivalent units to calculate the monthly allocations?

	Equivalent units for weighted average compared to FIFO	
	January	*February*
a.	Same	Same
b.	Greater number	Greater number
c.	Greater number	Same
d.	Same	Greater number

N90#42. A job order cost system uses a predetermined factory overhead rate based on expected volume and expected fixed cost. At the end of the year, underapplied overhead might be explained by which of the following situations?

	Actual volume	*Actual fixed costs*
a.	Greater than expected	Greater than expected
b.	Greater than expected	Less than expected
c.	Less than expected	Greater than expected
d.	Less than expected	Less than expected

M90#42. In process 2, material G is added when a batch is 60 percent complete. Ending work-in-process units, which are 50 percent complete, would be included in the computation of equivalent units for

	Conversion costs	*Material G*
a.	Yes	No
b.	No	Yes
c.	No	No
d.	Yes	Yes

N89#42. In a job order cost system, the use of indirect materials previously purchased usually is recorded as a decrease in

a. Stores control.
b. Work-in-process control.
c. Factory overhead control.
d. Factory overhead applied.

N88#42. The completion of goods is recorded as a decrease in work in process control when using

	Job order costing	*Process costing*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#42. In a job order cost system, the use of direct materials previously purchased usually is recorded as an increase in

a. Work in process control.
b. Factory overhead control.
c. Factory overhead applied.
d. Stores control.

C. Standard Costing

N91#42. A standard cost system may be used in

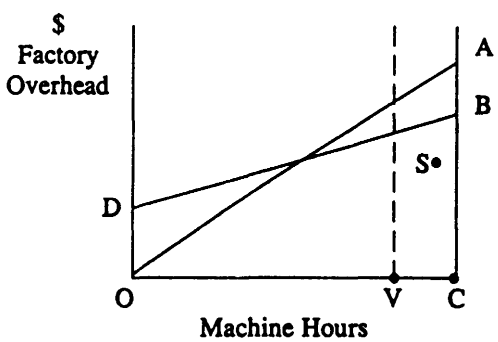
a. Neither process costing nor job order costing.
b. Process costing but **not** job order costing.
c. Either job order costing or process costing.
d. Job order costing but **not** process costing.

M91#43. During 1990, a department's three-variance overhead standard costing system reported unfavorable spending and volume variances. The activity level selected for allocating overhead to the product was based on 80% of practical capacity. If 100% of practical capacity had been selected instead, how would the reported unfavorable spending and volume variances be affected?

	Spending variance	Volume variance
a.	Increased	Unchanged
b.	Increased	Increased
c.	Unchanged	Increased
d.	Unchanged	Unchanged

N90
Item 43 is based on the following:

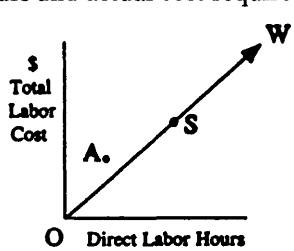
The diagram below depicts a factory overhead flexible budget line DB and standard overhead application line OA. Activity is expressed in machine hours with Point V indicating the standard hours required for the actual output in September 1990. Point S indicates the actual machine hours (inputs) and actual costs in September 1990.



43. Are the following overhead variances favorable or unfavorable?

	Volume (capacity) variance	Efficiency variance
a.	Favorable	Favorable
b.	Favorable	Unfavorable
c.	Unfavorable	Favorable
d.	Unfavorable	Unfavorable

M90#43. In the following diagram, the line OW represents the standard labor cost at any output volume expressed in direct labor hours. Point S indicates the actual output at standard cost, and Point A indicates the actual hours and actual cost required to produce S.



Which of the following variances are favorable or unfavorable?

	Rate variance	Efficiency variance
a.	Favorable	Unfavorable
b.	Favorable	Favorable
c.	Unfavorable	Unfavorable
d.	Unfavorable	Favorable

N89#43. Which of the following variances would be useful in calling attention to a possible short-term problem in the control of overhead costs?

	Spending variance	Volume variance
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

N88#43. Under the two-variance method for analyzing factory overhead, which of the following is used in the computation of the controllable (budget) variance?

	Budget allowance based on actual hours	Budget allowance based on standard hours
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M88#43. Under the two-variance method for analyzing factory overhead, the actual factory overhead is used in the computation of the

	Controllable (budget) variance	Volume variance
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

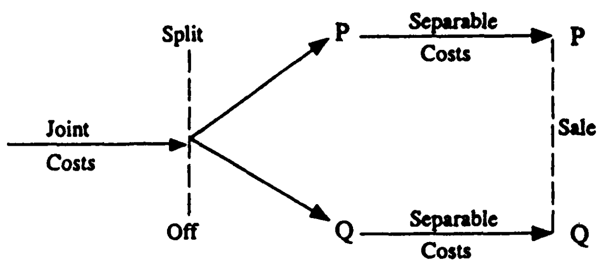
N91#44. During June, Delta Co. experienced scrap, normal spoilage, and abnormal spoilage in its manufacturing process. The cost of units produced includes

a. Scrap, but **not** spoilage.
b. Normal spoilage, but **neither** scrap **nor** abnormal spoilage.
c. Scrap and normal spoilage, but **not** abnormal spoilage.
d. Scrap, normal spoilage, and abnormal spoilage.

M91#41. A department adds material at the beginning of a process and identifies defective units when the process is 40% complete. At the beginning of the period, there was no work in process. At the end of the period, the number of work in process units equaled the number of units transferred to finished goods. If all units in ending work in process were 66⅔% complete, then ending work in process should be allocated

a. 50% of all normal defective unit costs.
b. 40% of all normal defective unit costs.
c. 50% of the material costs and 40% of the conversion costs of all normal defective unit costs.
d. None of the normal defective unit costs.

M90#44. The diagram below represents the production and sales relationships of joint products P and Q. Joint costs are incurred until split-off, then separable costs are incurred in refining each product. Market values of P and Q at split-off are used to allocate joint costs.



If the market value of P at split-off increases and all other costs and selling prices remain unchanged, then the gross margin of

	P	*Q*
a.	Increases	Decreases
b.	Increases	Increases
c.	Decreases	Decreases
d.	Decreases	Increases

N89#44. Actual sales values at the split-off point for joint products Y and Z are not known. For purposes of allocating joint costs to products Y and Z, the relative sales value at split-off method is used. An increase in the costs beyond split-off occurs for product Z, while those of product Y remain constant. If the selling prices of finished products Y and Z remain constant, the percentage of the total joint costs allocated to product Y and product Z would

a. Decrease for product Y and increase for product Z.
b. Decrease for product Y and product Z.
c. Increase for product Y and decrease for product Z.
d. Increase for product Y and product Z.

M89#44. Spoilage from a manufacturing process was discovered during an inspection of work in process. In a process costing system, the cost of the spoilage would be added to the cost of the good units produced if the spoilage is

	Abnormal	*Normal*
a.	No	Yes
b.	No	No
c.	Yes	Yes
d.	Yes	No

N88#44. The sale of scrap from a manufacturing process usually would be recorded as a(an)

a. Decrease in factory overhead control.
b. Increase in factory overhead control.
c. Decrease in finished goods control.
d. Increase in finished goods control.

M88#44. In accounting for byproducts, the value of the byproduct may be recognized at the time of

	Production	*Sale*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

E. Absorption and Variable Costing

M92#52. In calculating the break-even point for a multi-product company, which of the following assumptions are commonly made when variable costing is used?

I. Sales volume equals production volume.
II. Variable costs are constant per unit.
III. A given sales mix is maintained for all volume changes.

a. I and II.
b. I and III.
c. II and III.
d. I, II, and III.

N91#45. A single-product company prepares income statements using both absorption and variable costing methods. Manufacturing overhead cost applied per unit produced in 1990 was the same as in 1989. The 1990 variable costing statement reported a profit whereas the 1990 absorption costing statement reported a loss. The difference in reported income could be explained by units produced in 1990 being

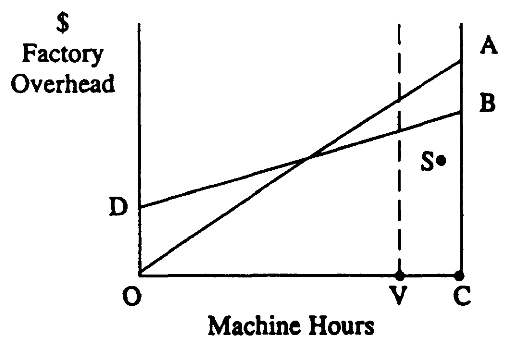
a. Less than units sold in 1990.
b. Less than the activity level used for allocating overhead to the product.
c. In excess of the activity level used for allocating overhead to the product.
d. In excess of units sold in 1990.

M91#45. In an income statement prepared as an internal report using the direct (variable) costing method, fixed selling and administrative expenses would

a. Be used in the computation of the contribution margin.
b. Be used in the computation of operating income but **not** in the computation of the contribution margin.
c. Be treated the same as variable selling and administrative expenses.
d. Not be used.

N90
Item 44 is based on the following:

The diagram below depicts a factory overhead flexible budget line DB and standard overhead application line OA. Activity is expressed in machine hours with Point V indicating the standard hours required for the actual output in September 1990. Point S indicates the actual machine hours (inputs) and actual costs in September 1990.



44. The budgeted total variable overhead cost for C machine hours is

a. AB
b. BC
c. AC minus DO
d. BC minus DO

M90#45. A manufacturing company prepares income statements using both absorption and variable costing methods. At the end of a period actual sales revenues, total gross profit, and total contribution margin approximated budgeted figures, whereas net income was substantially below the budgeted amount. There were no beginning or ending inventories. The most likely explanation of the net income shortfall is that, compared to budget, actual

a. Sales prices and variable costs had declined proportionately.
b. Sales prices had declined proportionately more than variable costs.
c. Manufacturing fixed costs had increased.
d. Selling and administrative fixed expenses had increased.

N89#46. In an income statement prepared as an internal report, total fixed costs normally would be shown separately under

	Absorption costing	*Variable costing*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M89#45. In an income statement prepared using the variable costing method, fixed factory overhead would

a. Not be used.
b. Be used in the computation of the contribution margin.
c. Be used in the computation of operating income but **not** in the computation of the contribution margin.
d. Be treated the same as variable factory overhead.

N88#45. In an income statement prepared as an internal report, operating income would normally be measured under

	Absorption costing	*Variable costing*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M88#45. In an income statement prepared as an internal report using the variable costing method, variable selling and administrative expenses would

a. Not be used.
b. Be treated the same as fixed selling and administrative expenses.
c. Be used in the computation of operating income but **not** in the computation of the contribution margin.
d. Be used in the computation of the contribution margin.

F. Budgeting and Flexible Budgeting

M92#53. When using a flexible budget, a decrease in production levels within a relevant range

a. Decreases variable cost per unit.
b. Decreases total costs.
c. Increases total fixed costs.
d. Increases variable cost per unit.

N91#46. When production levels are expected to decline within a relevant range, and a flexible budget is used, what effect would be anticipated with respect to each of the following?

	Variable costs per unit	Fixed costs per unit
a.	No change	No change
b.	Increase	No change
c.	No change	Increase
d.	Increase	Increase

M91#44. Lanta Restaurant compares monthly operating results with a static budget. When actual sales are less than budget, would Lanta usually report favorable variances on variable food costs and fixed supervisory salaries?

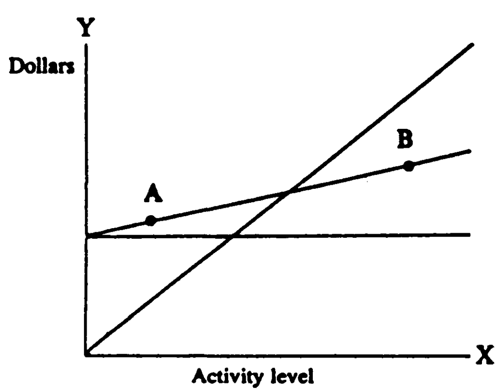
	Variable food costs	Fixed supervisory salaries
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N90#45. When a manager is concerned with monitoring total cost, total revenue, and net profit conditioned upon the level of productivity, an accountant would normally recommend

	Flexible budgeting	Standard costing
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M90
Item 46 is based on the following:

The diagram below is a cost-volume-profit chart.



46. At point A compared to point B, as a percentage of sales revenues

	Variable costs are	Fixed costs are
a.	Greater	Greater
b.	Greater	The same
c.	The same	The same
d.	The same	Greater

M89#46. A flexible budget is appropriate for a(an)

	Administrative budget	Marketing budget
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#46. When a flexible budget is used, an increase in production levels within the relevant range would
a. Not change variable costs per unit.
b. Not change total variable costs.
c. Not change fixed costs per unit.
d. Change total fixed costs.

M88#46. The flexible budget for a company may include

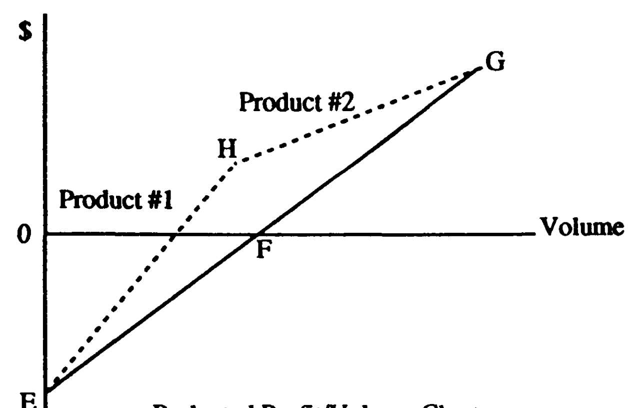
	Direct material costs	Variable selling costs
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

G. Breakeven and Cost-Volume-Profit Analysis

M92#54. On January 1, 1992, Lake Co. increased its direct labor wage rates. All other budgeted costs and revenues were unchanged. How did this increase affect Lake's budgeted break-even point and budgeted margin of safety?

	Budgeted break-even point	Budgeted margin of safety
a.	Increase	Increase
b.	Increase	Decrease
c.	Decrease	Decrease
d.	Decrease	Increase

N91#47. In the budgeted profit/volume chart below, EG represents a two-product company's profit path. EH and HG represent the profit paths of products #1 and #2, respectively.

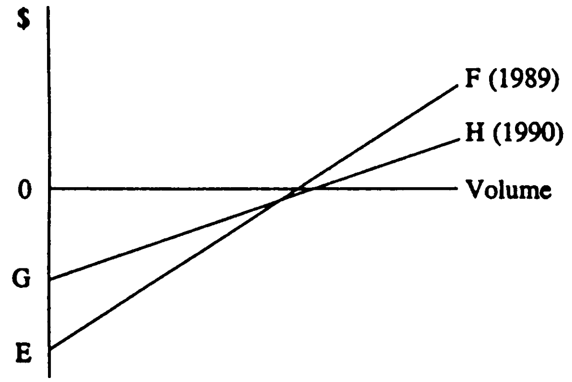


Budgeted Profit/Volume Chart

Sales prices and cost behavior were as budgeted, actual total sales equaled budgeted sales, and there were no inventories. Actual profit was greater than budgeted profit. Which product had actual sales in excess of budget, and what margin does OE divided by OF represent?

	Product with excess sales	*OE/OF*
a.	#1	Contribution margin
b.	#1	Gross margin
c.	#2	Contribution margin
d.	#2	Gross margin

M91#49. In the profit-volume chart below, EF and GH represent the profit-volume graphs of a single-product company for 1989 and 1990, respectively.

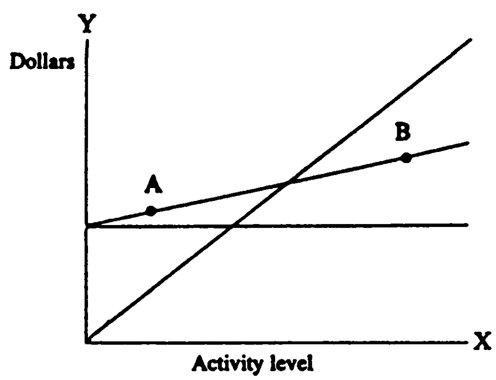


If 1989 and 1990 unit sales prices are identical, how did total fixed costs and unit variable costs of 1990 change compared to 1989?

	1990 total fixed costs	*1990 unit variable costs*
a.	Decreased	Increased
b.	Decreased	Decreased
c.	Increased	Increased
d.	Increased	Decreased

M90
Item 47 is based on the following:

The diagram below is a cost-volume-profit chart.



47. If sales dollars are used to measure activity levels, total costs and total revenues may be read from the X and Y axes as follows:

	Total costs	*Total revenues*
a.	X or Y	X or Y
b.	X or Y	X only
c.	Y only	X or Y
d.	Y only	X only

N89#47. Breakeven analysis assumes that over the relevant range
  a. Unit variable costs are unchanged.
  b. Total fixed costs are nonlinear.
  c. Unit revenues are nonlinear.
  d. Total costs are unchanged.

M89#47. Breakeven analysis assumes that over the relevant range
  a. Total costs are unchanged.
  b. Unit variable costs are unchanged.
  c. Variable costs are nonlinear.
  d. Unit fixed costs are unchanged.

N88#47. Breakeven analysis assumes that over the relevant range total
  a. Revenues are linear.
  b. Costs are unchanged.
  c. Variable costs are nonlinear.
  d. Fixed costs are nonlinear.

M88#47. Breakeven analysis assumes that over the relevant range
  a. Variable costs are nonlinear.
  b. Fixed costs are nonlinear.
  c. Selling prices are unchanged.
  d. Total costs are unchanged.

H. Capital Budgeting Techniques

N91#49. How are the following used in the calculation of the internal rate of return of a proposed project? Ignore income tax considerations.

	Residual sales value of project	*Depreciation expense*
a.	Exclude	Include
b.	Include	Include
c.	Exclude	Exclude
d.	Include	Exclude

M91#48. The discount rate (hurdle rate of return) must be determined in advance for the
  a. Payback period method.
  b. Time adjusted rate of return method.
  c. Net present value method.
  d. Internal rate of return method.

N90#46. On November 1, 1990, a company purchased a new machine that it does not have to pay for until November 1, 1992. The total payment on November 1, 1992, will include both principal and interest. Assuming interest at a 10% rate, the cost of the machine would be the total payment multiplied by what time value of money concept?

a. Present value of annuity of 1.
b. Present value of 1.
c. Future amount of annuity of 1.
d. Future amount of 1.

N90#47. Which of the following capital budgeting techniques implicitly assumes that the cash flows are reinvested at the company's minimum required rate of return?

	Net present value	*Internal rate of return*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M90#48. Polo Co. requires higher rates of return for projects with a life span greater than five years. Projects extending beyond five years must earn a higher specified rate of return. Which of the following capital budgeting techniques can readily accommodate this requirement?

	Internal rate of return	*Net present value*
a.	Yes	No
b.	No	Yes
c.	No	No
d.	Yes	Yes

N89#48. The capital budgeting technique known as accounting rate of return uses

	Revenue over life of project	*Depreciation expense*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M89#48. The capital budgeting technique known as payback period uses

	Depreciation expense	*Time value of money*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#48. The capital budgeting technique known as net present value uses

	Cash flow over life of project	*Time value of money*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M88#48. The capital budgeting technique known as internal rate of return uses

	Cash flow over entire life of project	*Time value of money*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

I. Performance Analysis

M92#55. Book Co. uses the activity-based costing approach for cost allocation and product costing purposes. Printing, cutting, and binding functions make up the manufacturing process. Machinery and equipment are arranged in operating cells that produce a complete product starting with raw materials. Which of the following are characteristic of Book's activity-based costing approach?

I. Cost drivers are used as a basis for cost allocation.
II. Costs are accumulated by department or function for purposes of product costing.
III. Activities that do not add value to the product are identified and reduced to the extent possible.

a. I only.
b. I and II.
c. I and III.
d. II and III.

N91#50. Which combination of changes in asset turnover and income as a percentage of sales will maximize the return on investment?

	Asset turnover	*Income as a percentage of sales*
a.	Increase	Decrease
b.	Increase	Increase
c.	Decrease	Increase
d.	Decrease	Decrease

M91#47. Controllable revenues would be included in the performance reports of which of the following types of responsibility centers?

	Cost centers	*Investment centers*
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

N90#48. Division A is considering a project that will earn a rate of return which is greater than the imputed interest charge for invested capital, but less than the division's historical return on invested capital. Division B is considering a project that will earn a rate of return which is greater than the division's historical return on invested capital, but less than the imputed interest charge for invested capital. If the objective is to maximize residual income, should these divisions accept or reject their projects?

	A	*B*
a.	Accept	Accept
b.	Reject	Accept
c.	Reject	Reject
d.	Accept	Reject

M90#49. A company's return on investment is the
- a. Profit margin percentage divided by the capital turnover.
- b. Profit margin percentage multiplied by the capital turnover.
- c. Capital turnover divided by invested capital.
- d. Capital turnover multiplied by invested capital.

N89#49. A company is analyzing the performance of responsibility centers. Controllable revenues would be included in the performance reports of which of the following types of responsibility centers?

	Investment centers	*Profit centers*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M89#49. Residual income is income
- a. To which an imputed interest charge for invested capital is added.
- b. From which an imputed interest charge for invested capital is deducted.
- c. From which dividends are deducted.
- d. To which dividends are added.

N88#49. The calculation of a company's return on investment is affected by a change in

	Capital turnover	*Profit margin on sales*
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

M88#49. A company is analyzing the performance of responsibility centers. Controllable costs would be included in the performance reports of which of the following types of responsibility centers?

	Investment centers	*Profit centers*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

J. Other

M92#56. Buff Co. is considering replacing an old machine with a new machine. Which of the following items is economically relevant to Buff's decision? (Ignore income tax considerations.)

	Carrying amount of old machine	*Disposal value of new machine*
a.	Yes	No
b.	No	Yes
c.	No	No
d.	Yes	Yes

N91#48. Probability (risk) analysis is
- a. An extension of sensitivity analysis.
- b. Incompatible with sensitivity analysis.
- c. Used only for situations involving five or fewer possible outcomes.
- d. Used only for situations in which the summation of probability weights is less than one.

M91#50. The economic order quantity formula assumes that
- a. Purchase costs per unit differ due to quantity discounts.
- b. Costs of placing an order vary with quantity ordered.
- c. Periodic demand for the good is known.
- d. Erratic usage rates are cushioned by safety stocks.

N90#49. When only differential manufacturing costs are taken into account for special order pricing, an essential assumption is that
- a. Manufacturing fixed and variable costs are linear.
- b. Selling and administrative fixed and variable costs are linear.
- c. Acceptance of the order will **not** affect regular sales
- d. Acceptance of the order will **not** cause unit selling and administrative variable costs to increase.

N90#50. Which of the following may be used to estimate how inventory warehouse costs are affected by both the number of shipments and the weight of materials handled?
- a. Economic order quantity analysis.
- b. Probability analysis.
- c. Correlation analysis.
- d. Multiple regression analysis.

M90#50. In statistical analysis, a weighted average using probabilities as weights is the
a. Objective function.
b. Coefficient of variation.
c. Expected value.
d. Standard deviation.

N89#50. A company is considering exchanging an old asset for a new asset. Ignoring income tax considerations, which of the following is economically relevant to the decision?

	Original cost of old asset	*Fair market value of old asset*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M89#50. Which of the following would be included in the economic order quantity formula?

	Inventory carrying cost	*Stockout cost*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#50. Multiple regression analysis involves the use of

	Dependent variables	*Independent variables*
a.	One	More than one
b.	More than one	More than one
c.	More than one	One
d.	One	One

VIII. Not-for-Profit and Governmental Accounting

A. Conceptual Framework

M92#57. Under the modified accrual basis of accounting for a governmental unit, revenues that are measurable should be recognized in the accounting period in which they are
a. Earned.
b. Available.
c. Budgeted.
d. Collected.

N91#51. One feature of state and local government accounting and financial reporting is that fixed assets used for general government activities
a. Often are **not** expected to contribute to the generation of revenues.
b. Do **not** depreciate as a result of such use.
c. Are acquired only when direct contribution to revenues is expected.
d. Should **not** be maintained at the same level as those of businesses so that current financial resources can be used for other government services.

M91#51. The primary authoritative body for determining the measurement focus and basis of accounting standards for governmental fund operating statements is the
a. Governmental Accounting Standards Board (GASB).
b. National Council on Governmental Accounting (NCGA).
c. Government Accounting and Auditing Committee of the AICPA (GAAC).
d. Financial Accounting Standards Board (FASB).

N90#51. Which of the following bases of accounting should a government use for its proprietary funds in measuring financial position and operating results?

	Modified accrual basis	*Accrual basis*
a.	No	Yes
b.	No	No
c.	Yes	Yes
d.	Yes	No

M90#59. Fixed assets donated to a governmental unit should be recorded
a. As a memorandum entry only.
b. At the donor's carrying amount.
c. At estimated fair value when received.
d. At the lower of donor's carrying amount or estimated fair value when received.

N89#51. The modified accrual basis of accounting is appropriate for which of the following fund categories of a county government?

	Governmental	*Proprietary*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M89#51. Under the modified accrual basis of accounting for a governmental unit, revenues should be recognized in the accounting period in which they
a. Are earned and become measurable.
b. Are collected.
c. Become available and measurable.
d. Become available and earned.

N88#51. Which of the following is an appropriate basis of accounting for a proprietary fund of a governmental unit?

	Cash basis	*Modified accrual basis*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M88#51. Which of the following is an appropriate basis of accounting for a governmental fund of a governmental unit?

	Accrual basis	*Modified accrual basis*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

B. Fund Accounting

M92#58. Property taxes levied in fiscal year 1991 to finance the general fund budget of fiscal year 1992 should be reported as general fund revenues in fiscal year 1992

a. Regardless of the fiscal year in which collected.
b. For the amount collected in fiscal year 1992 only.
c. For the amount collected before the end of fiscal year 1992 only.
d. For the amount collected before the end of fiscal year 1992 or shortly thereafter.

N91#52. If a city legally adopts its annual general fund budget on the modified accrual basis of accounting, its estimated revenues should be

a. Reported on the modified accrual basis of accounting in the general fund statement of revenues, expenditures, and changes in fund balance—budget and actual.
b. Converted to the cash basis of accounting and reported in the general fund statement of revenues, expenditures, and other changes in fund balance—budget and actual.
c. Reported as current assets in the general fund balance sheet.
d. Reported as noncurrent assets in the general fund balance sheet.

N91#53. Gold County received goods that had been approved for purchase but for which payment had not yet been made. Should the accounts listed below be increased?

	Encumbrances	*Expenditures*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

M91#52. The budget of a governmental unit, for which the appropriations exceed the estimated revenues, was adopted and recorded in the general ledger at the beginning of the year. During the year, expenditures and encumbrances were less than appropriations; whereas revenues equaled estimated revenues. The budgetary fund balance account is

a. Credited at the beginning of the year and debited at the end of the year.
b. Credited at the beginning of the year and **not** changed at the end of the year.
c. Debited at the beginning of the year and credited at the end of the year.
d. Debited at the beginning of the year and **not** changed at the end of the year.

M91#53. Which of the following amounts are included in a general fund's encumbrance account?

I. Outstanding vouchers payable amounts.
II. Outstanding purchase order amounts.
III. Excess of the amount of a purchase order over the actual expenditure for that order.

a. I only.
b. I and III.
c. II only.
d. II and III.

M90
Items 52 and 54 are based on the following:

Todd City formally integrates budgetary accounts into its general fund. Todd uses an internal service fund to account for the operations of its data processing center, which provides services to Todd's other governmental units.

During the year ended December 31, 1989, Todd received a state grant to buy a bus, and an additional grant for bus operation in 1989. In 1989, only 90% of the capital grant was used for the bus purchase, but 100% of the operating grant was disbursed.

Todd has incurred the following long-term obligations:

- General obligation bonds issued for the water and sewer fund which will service the debt.
- Revenue bonds to be repaid from admission fees collected from users of the municipal recreation center.

These bonds are expected to be paid from enterprise funds, and secured by Todd's full faith, credit, and taxing power as further assurance that the obligations will be paid.

Todd's 1989 expenditures from the general fund include payments for structural alterations to a firehouse and furniture for the mayor's office.

52. In reporting the state grants for the bus purchase and operation, what should Todd include as grant revenues for the year ended December 31, 1989?

	90% of the capital grant	*100% of the capital grant*	*Operating grant*
a.	Yes	No	No
b.	No	Yes	No
c.	No	Yes	Yes
d.	Yes	No	Yes

54. When Todd records its annual budget, which of the following control accounts indicates the amount of the authorized spending limitation for the year ending December 31, 1989?
   a. Reserved for appropriations.
   b. Appropriations.
   c. Reserved for encumbrances.
   d. Encumbrances.

N89#52. The estimated revenues control account balance of a governmental fund type is eliminated when
   a. The budgetary accounts are closed.
   b. The budget is recorded.
   c. Property taxes are recorded.
   d. Appropriations are closed.

M89#52. The encumbrances control account of a governmental unit is increased when

	A voucher payable is recorded	*The budgetary accounts are closed*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M89#53. The expenditures control account of a governmental unit is increased when

	A purchase order is approved	*The budget is recorded*
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N88#53. The appropriations control account of a governmental unit is debited when

	The budgetary accounts are closed	*Expenditures are recorded*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M88#52. The fund balance reserved for encumbrances account of a governmental unit is decreased when
   a. Supplies previously ordered are received.
   b. A purchase order is approved.
   c. The vouchers are paid.
   d. Appropriations are recorded.

M88#53. The revenues control account of a governmental unit is increased when
   a. The budget is recorded.
   b. Property taxes are recorded.
   c. Appropriations are recorded.
   d. The budgetary accounts are closed.

C. Types of Funds and Account Groups

N91#54. In which of the following fund types of a city government are revenues and expenditures recognized on the same basis of accounting as the general fund?
   a. Nonexpendable trust.
   b. Internal service.
   c. Enterprise.
   d. Debt service.

N91#55. An enterprise fund would be used when the governing body requires that

I. Accounting for the financing of an agency's services to other government departments be on a cost-reimbursement basis.
II. User charges cover the costs of general public services.
III. Net income information be provided for an activity.

   a. I only.
   b. I and II.
   c. I and III.
   d. II and III.

N91#56. On June 28, 1991, Silver City's debt service fund received funds for the future repayment of bond principal. As a consequence, the long-term debt account group reported
   a. An increase in the amount available in debt service funds and an increase in the fund balance.
   b. An increase in the amount available in debt service funds and an increase in the amount to be provided for bonds.
   c. An increase in the amount available in debt service funds and a decrease in the amount to be provided for bonds.
   d. No changes in any amount until the bond principal is actually paid.

N91#57. Funds received by a college from donors who have stipulated that the principal is nonexpendable but

that the income generated may be expended by current operating funds would be accounted for in the
a. Endowment fund.
b. Term endowment fund.
c. Agency fund.
d. Quasi-endowment fund.

M91#54. Tott City's serial bonds are serviced through a debt service fund with cash provided by the general fund. In a debt service fund's statements, how are cash receipts and cash payments reported?

	Cash receipts	*Cash payments*
a.	Revenues	Expenditures
b.	Revenues	Operating transfers
c.	Operating transfers	Expenditures
d.	Operating transfers	Operating transfers

M91#55. Taxes collected and held by Eldorado County for a school district would be accounted for in which of the following funds?
a. Trust.
b. Agency.
c. Special revenue.
d. Internal service.

M91#56. Old equipment, which is recorded in the general fixed asset account group, is sold for less than its carrying amount. The sale reduces the investments in general fixed assets' balance by the
a. Difference between the cost of the equipment and the sales price.
b. Difference between the carrying amount of the equipment and the sales price.
c. Selling price of the equipment.
d. Carrying amount of the equipment.

M91#57. An alumnus donates securities to Rex College and stipulates that the principal be held in perpetuity and revenues be used for faculty travel. Dividends received from the securities should be recognized as revenues in
a. Endowment funds.
b. Quasi-endowment funds.
c. Restricted current funds.
d. Unrestricted current funds.

M91#58. A college's plant funds group includes which of the following subgroups?

I. Renewals and replacement funds.
II. Retirement of indebtedness funds.
III. Restricted current funds.
a. I and II.
b. I and III.
c. II and III.
d. I only.

N90#52. Which of the following fund types used by a government most likely would have a Fund Balance Reserved for Inventory of Supplies?
a. General.
b. Internal service.
c. Nonexpendable trust.
d. Capital projects.

N90#53. Should a special revenue fund with a legally adopted budget maintain its accounts on an accrual basis and integrate budgetary accounts into its accounting system?

	Maintain on accrual basis	*Integrate budgetary accounts*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N90
Items 54 through 57 are based on the following:

On March 2, 1990, Finch City issued 10-year general obligation bonds at face amount, with interest payable March 1 and September 1. The proceeds were to be used to finance the construction of a civic center over the period April 1, 1990, to March 31, 1991. During the fiscal year ended June 30, 1990, no resources had been provided to the debt service fund for the payment of principal and interest.

54. On June 30, 1990, Finch's debt service fund should include interest payable on the general obligation bonds for
a. 0 months.
b. 3 months.
c. 4 months.
d. 6 months.

55. Proceeds from the general obligation bonds should be recorded in the
a. General fund.
b. Capital projects fund.
c. General long-term debt account group.
d. Debt service fund.

56. The liability for the general obligation bonds should be recorded in the
a. General fund.
b. Capital projects fund.
c. General long-term debt account group.
d. Debt service fund.

57. On June 30, 1990, Finch's combined balance sheet should report the construction in progress for the civic center in the

	Capital projects fund	*General fixed assets account group*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N90#58. Which of the following fund types or account group should account for fixed assets in a manner similar to a "for profit" organization?
a. Special revenue fund.
b. Capital projects fund.
c. General fixed assets account group.
d. Enterprise fund.

N90#59. Which of the following fund types would include retained earnings in its balance sheet?
a. Special revenue.
b. Capital projects.
c. Expendable pension trust.
d. Internal service.

M90
Items 51 and 53 are based on the following:

Todd City formally integrates budgetary accounts into its general fund. Todd uses an internal service fund to account for the operations of its data processing center, which provides services to Todd's other governmental units.

During the year ended December 31, 1989, Todd received a state grant to buy a bus, and an additional grant for bus operation in 1989. In 1989, only 90% of the capital grant was used for the bus purchase, but 100% of the operating grant was disbursed.

Todd has incurred the following long-term obligations:

- General obligation bonds issued for the water and sewer fund which will service the debt.
- Revenue bonds to be repaid from admission fees collected from users of the municipal recreation center.

These bonds are expected to be paid from enterprise funds, and secured by Todd's full faith, credit, and taxing power as further assurance that the obligations will be paid.

Todd's 1989 expenditures from the general fund include payments for structural alterations to a firehouse and furniture for the mayor's office.

51. To record the billing for data processing services provided to Todd's other governmental units, the internal service fund should credit
a. Operating revenues.
b. Data processing departmental expenses.
c. Intergovernmental transfers.
d. Interfund exchanges.

53. Which of Todd's long-term obligations should be accounted for in the general long-term debt account group?

	General obligation bonds	*Revenue bonds*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M90#56. Revenues that are legally restricted to expenditures for specified purposes should be accounted for in special revenue funds, including
a. Accumulation of resources for payment of general long-term debt principal and interest.
b. Pension trust fund revenues.
c. Gasoline taxes to finance road repairs.
d. Proprietary fund revenues.

M90#57. The basis of accounting for a capital projects fund is the
a. Cash basis.
b. Accrual basis.
c. Modified cash basis.
d. Modified accrual basis.

N89#54. Fixed assets used by a governmental unit should be accounted for in the

	Capital projects fund	*General fund*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N89#55. Which of the following funds of a governmental unit uses the same basis of accounting as the enterprise fund?
a. Nonexpendable trust funds.
b. Expendable trust funds.
c. Special revenue funds.
d. Capital projects funds.

N89#56. Fixed assets should be accounted for in the general fixed assets account group for the

	Enterprise fund	*Special revenue fund*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N89#57. Customers' security deposits that cannot be spent for normal operating purposes were collected by a governmental unit and accounted for in the enterprise fund. A portion of the amount collected was invested in marketable debt securities and a portion in marketable equity securities. How would each portion be classified in the balance sheet?

	Portion in marketable debt securities	*Portion in marketable equity securities*
a.	Unrestricted asset	Restricted asset
b.	Unrestricted asset	Unrestricted asset
c.	Restricted asset	Unrestricted asset
d.	Restricted asset	Restricted asset

M89#54. Which one of the following funds of a governmental unit is a governmental fund?

a. Enterprise funds.
b. Internal service funds.
c. Debt service funds.
d. Nonexpendable trust funds.

M89#55. Fixed assets of an enterprise fund should be accounted for in the

a. Enterprise fund but **no** depreciation on the fixed assets should be recorded.
b. Enterprise fund and depreciation on the fixed assets should be recorded.
c. General fixed asset account group but **no** depreciation on the fixed assets should be recorded.
d. General fixed asset account group and depreciation on the fixed assets should be recorded.

M89#56. Unmatured general obligation bonds payable of a governmental unit should be reported in the liability section of the

a. General fund.
b. Capital projects fund.
c. General long-term debt account group.
d. Debt service fund.

N88#54. Which of the following funds of a governmental unit recognizes revenues in the accounting period in which they become available and measurable?

a. Capital projects funds.
b. Nonexpendable trust funds.
c. Enterprise funds.
d. Internal service funds.

N88#56. Fixed assets should be accounted for in the general fixed assets account group for the

	Internal service fund	*Special revenue fund*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N88#57. Which of the following would appear in the plant fund of a voluntary health and welfare organization?

	Land	*Equipment*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#54. Which of the following funds of a governmental unit uses the modified accrual basis of accounting?

a. Enterprise funds.
b. Internal service funds.
c. Nonexpendable trust funds.
d. Special revenue funds.

M88#55. Which of the following funds of a governmental unit uses the same basis of accounting as the special revenue fund?

a. Expendable trust funds.
b. Nonexpendable trust funds.
c. Enterprise funds.
d. Internal service funds.

M88#56. The amount available in debt service funds is an account of a governmental unit that would be included in the

a. Liability section of the general long-term debt account group.
b. Liability section of the debt service fund.
c. Asset section of the general long-term debt account group.
d. Asset section of the debt service fund.

M88#57. Customers' security deposits that cannot be spent for normal operating purposes were collected by a governmental unit and accounted for in the enterprise fund. A portion of the amount collected was invested in marketable securities. How would the portion in cash and the portion in marketable securities be classified in the balance sheet of the enterprise fund?

	Portion in cash	*Portion in marketable securities*
a.	Restricted asset	Restricted asset
b.	Restricted asset	Unrestricted asset
c.	Unrestricted asset	Unrestricted asset
d.	Unrestricted asset	Restricted asset

D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

N91#58. Clover City's comprehensive annual financial report contains both combining and combined financial statements. Total columns are

a. Required for both combining and combined financial statements.

b. Optional, but commonly shown, for combining financial statements and required for combined financial statements.
c. Required for combining financial statements and optional, but commonly shown, for combined financial statements.
d. Optional, but commonly shown, for both combining and combined financial statements.

M91#59. In a government's comprehensive annual financial report (CAFR), account groups are included in which of the following combined financial statements?

	Balance sheet	*Statement of revenues, expenditures, and changes in fund balances*
a.	Yes	No
b.	No	Yes
c.	Yes	Yes
d.	No	No

N90#60. An increase in Oak College's restricted current funds balance could be reported as an excess of

a. Transfers to revenues over restricted receipts.
b. Restricted receipts over transfers to revenues.
c. Revenues over expenditures and mandatory transfers.
d. Revenues and mandatory transfers over expenditures.

M90
Item 55 is based on the following:

Todd City formally integrates budgetary accounts into its general fund. Todd uses an internal service fund to account for the operations of its data processing center, which provides services to Todd's other governmental units.

During the year ended December 31, 1989, Todd received a state grant to buy a bus, and an additional grant for bus operation in 1989. In 1989, only 90% of the capital grant was used for the bus purchase, but 100% of the operating grant was disbursed.

Todd has incurred the following long-term obligations:

- General obligation bonds issued for the water and sewer fund which will service the debt.
- Revenue bonds to be repaid from admission fees collected from users of the municipal recreation center.

These bonds are expected to be paid from enterprise funds, and secured by Todd's full faith, credit, and taxing power as further assurance that the obligations will be paid.

Todd's 1989 expenditures from the general fund include payments for structural alterations to a firehouse and furniture for the mayor's office.

55. In Todd's general fund balance sheet presentation at December 31, 1989, which of the following expenditures should be classified as fixed assets?

	Structural alterations to firehouse	*Mayor's office furniture*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

N89#60. The comprehensive annual financial report (CAFR) of a city should contain a combined statement of revenues, expenditures, and changes in fund balances for

	Account groups	*Proprietary funds*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M89#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenses, and changes in retained earnings for

	Account groups	*Proprietary funds*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenditures, and changes in fund balances for

	Governmental funds	*Proprietary funds*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenses, and changes in retained earnings for

	Account groups	*Governmental funds*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

E. Various Types of Not-for-Profit and Governmental Organizations

M92#59. Is the recognition of depreciation expense required for public colleges and private not-for-profit colleges?

	Public	*Private*
a.	No	Yes
b.	No	No
c.	Yes	Yes
d.	Yes	No

M92#60. Unrestricted earnings on specific purpose fund investments that are part of a hospital's central operations are reported as

a. Increases in the specific purpose fund balance.
b. Specific purpose fund revenues.
c. General fund deferred revenues.
d. General fund revenues.

N91#59. Dee City's community hospital, which uses enterprise fund reporting, normally includes proceeds from sale of cafeteria meals in

a. Patient service revenues.
b. Other revenues.
c. Ancillary service revenues.
d. Deductions from dietary service expenses.

N91#60. A nonprofit performing arts organization receives a donation that is restricted to its endowment and another donation that is restricted for use in acquiring a performing arts center. How should these donations be reported in the year received, assuming neither donation is expended in that year?

	Donation for endowment	*Donation for performing arts center*
a.	Deferred capital additions	Deferred capital additions
b.	Deferred capital additions	Capital additions
c.	Capital additions	Capital additions
d.	Capital additions	Deferred capital additions

M90#58. For state and local governmental units, generally accepted accounting principles require that encumbrances outstanding at year-end be reported as

a. Expenditures.
b. Reservations of fund balance.
c. Deferred liabilities.
d. Current liabilities.

M90#60. Which of the following should be included in a university's current funds revenue?

	Unrestricted gifts	*Expended restricted current funds*	*Unexpended restricted current funds*
a.	Yes	Yes	Yes
b.	Yes	Yes	No
c.	Yes	No	No
d.	No	No	Yes

N89#58. In a statement of support, revenue, and expenses and changes in fund balances of a voluntary health and welfare organization, depreciation expense should

a. Be included as an element of expense.
b. Be included as an element of other changes in fund balances.
c. Be included as an element of support.
d. Not be included.

M89#59. A local governmental unit could have funds using which of the following accounting bases?

	Accrual basis	*Modified accrual basis*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M89#60. Which of the following funds are usually encountered in a not-for-profit private university?

	Loan funds	*Life income funds*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N88#60. In a statement of support, revenue, and expenses and changes in fund balances of a voluntary health and welfare organization, contributions to the building fund should

a. Be included as an element of support.
b. Be included as an element of revenue.
c. Be included as an element of other changes in fund balances.
d. Not be included.

M88#59. Which of the following funds are usually encountered in a not-for-profit private university?

	Current funds	*Plant funds*
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

A. Authority of Pronouncements

M92# 1 d

B. Conceptual Framework

M92# 2 d
M92# 3 b
N91# 1 c
M91# 1 a
N90# 1 a
N89# 1 d
M89# 1 a
N88# 1 b
M88# 1 b
M88# 2 b

E. Consolidated Financial Statements

N91# 9 a
N90# 2 c
M90# 2 a
M88# 3 b

F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

M92# 4 c
M92# 5 a
N91# 7 a
M91# 2 a
M91# 3 b
N90# 11 b
M90# 3 d

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

M92#42 a
N91#36 a
M91# 4 b
N90# 6 d
M90# 4 b
N89# 2 d
N89# 3 d
N89# 4 d
N89# 5 a
N88# 2 b
N88# 3 b
N88# 4 c
N88# 5 d
M88# 5 a
M88# 6 c

B. Receivables and Accruals

M92#21 b
M92#41 c
M92#47 a
N91# 6 c
M91#10 a
M91#21 a
N89# 6 b
N89# 7 a
M89# 2 b
M89# 3 c
M88# 7 b

C. Inventories

M92#23 c
M92#24 a
M92#25 b
N91#27 a
N91#28 b
N90#15 a
N90#16 a
N90#17 c
N89# 8 d
N89# 9 c
N89#10 b
N88# 6 a
N88# 7 a
N88# 8 b

D. Property, Plant, and Equipment Owned or Leased

M92#11 b
M92#12 c
M92#13 a
M92#16 b
N91#33 b
N90#13 a
M89# 4 d
M89# 5 b
M88# 8 c
M88# 9 b

E. Intangibles and Other Assets

M92#14 a
N91#13 a
M91#11 c
N90#21 d
M90# 6 b
N89#11 a
N89#12 c
M89# 6 c
N88# 9 c
M88#10 d

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals

M92#19 d
M92#26 c
N91#31 b
M91#13 d
M91#14 d
N90#20 b
N90#22 a
M90# 7 c
M90# 8 b
N89#13 c
N88#10 b
M88#11 a

B. Deferred Revenues

M92#32 d
N91#19 d
M91#15 d
N90#23 a
N90#24 d
M90# 9 b
N89#14 b
N88#11 d
M88#12 b

C. Deferred Income Tax Liabilities

M92# 9 b
N91# 4 b
N89#15 d

D. Capitalized Lease Liability

M92#33 d
N91#34 a
M90#11 a
N89#16 b
N88#13 b

E. Bonds Payable

N91#35 c
N91#37 c
M91# 5 b
M91# 6 c
N90#29 d
N90#30 c
N90#31 a
N89#17 c
N89#18 c
N89#19 b
N88#14 d
N88#15 b
N88#16 c
M88#14 a
M88#15 c
M88#16 c

F. Contingent Liabilities and Commitments

M92#27 b
M91#16 c
N90#35 d
M90#12 d
M88#17 d

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock

N91#40 c
M90#13 c
M89# 8 b
N88#17 d

B. Additional Paid-in Capital

N89#20 d

C. Retained Earnings and Dividends

M92#37 d
N91#25 a
M91#17 b
N90#32 c
N90#36 b
M90#14 a
N89#21 b
N88#18 b
M88#19 c

D. Treasury Stock and Other Contra Accounts

M92#38 a
N91#39 c
M91#18 b
N90#33 c
M90#15 b
N89#22 b
M89#10 c
N88#19 c

E. Stock Options, Warrants, and Rights

N91#38 d
M91#19 d
M90#16 a
N89#23 a
M89#11 c
N88#20 c
M88#21 a

G. Partnerships

M92#35 d
N91#15 b
M91#39 d
N90#40 a
M90#17 d
N89#24 c
M89#12 d
N88#21 d
M88#22 c

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

A. Revenues and Gains

M92# 6 c
M92#39 b
M92#43 d
M92#44 b
M92#45 c
M92#46 b
N91# 5 d
N91#10 b
N91#14 d
N91#20 d
M91# 8 c
M91# 9 a
M91#20 b
M91#22 b
M91#28 d
N90#26 c
N90#37 b
N90#39 d
M90#18 b
M90#20 b
N89#25 a
M89#13 a
M89#14 a
M89#15 b
M89#16 b
N88#22 c
N88#24 c
N88#25 a
M88#23 d

B. Expenses and Losses

M92#15 a
M92#17 b
M92#18 c
M92#20 c
M92#22 a
M92#29 a
M92#31 d
M92#34 a
M92#36 d
N91#18 b
N91#29 c
N91#32 a
M91#23 d
M91#25 d
N90#14 d
N90#19 c
M90#21 b
M90#22 b
M90#24 d
M89#17 b
M89#18 d
M89#19 c

M89#20 a
M89#21 b
N88#26 c
N88#27 b
N88#28 d
N88#29 b
M88#25 b
M88#26 c

C. Provision for Income Tax

M92#10 c
N91# 3 c
N89#27 c
M89#22 a

D. Recurring Versus Nonrecurring Transactions and Events

M92#30 d
N91#23 c
M91#26 b
N90#38 a
M90#26 a
M89#23 b
N88#31 a
M88#28 a

E. Accounting Changes

N91#26 d
M91#34 d
M89#24 a
N88#32 d

F. Earnings Per Share

N91#16 b
M91#29 b
N90#34 b
M90#29 c
N89#28 a
M89#25 c
N88#33 c

VI. Other Financial Topics

A. Statement of Cash Flows

M92# 7 a
M92# 8 d
N91#21 c
N91#22 a
M91#30 c
M91#31 d
M90#27 a
M90#28 c
N89#29 d
N89#30 b
M89#26 c
M89#27 a

B. Accounting Policies

M91#32 b
M90#30 c
M89#28 c
M88#32 b

C. Accounting Changes

M92#40 d
N91#24 c
M91#27 d
M89#29 c

D. Nonmonetary Transactions

M91#35 c
N90#12 d
M90#31 a
N89#34 c
N88#36 d

E. Business Combinations

N91#11 d
N91#12 b
N90# 4 d
N90# 5 b
M90#32 c
M90#33 c
N89#32 a
N89#33 d
M89#30 b
M89#31 c

F. Interim Financial Statements

N91# 2 d
M91#36 d
N90# 7 c
M90#34 b
N89#35 d
M89#32 b
N88#37 b

G. Gain Contingencies

M92#28 d
M90#35 c
M89#33 c

H. Segments and Lines of Business

M91#33 c
M90#36 c
N89#36 c
M89#34 c
M88#37 b

I. Employee Benefits

N91#30 b
M91#37 b
M90#37 c
M89#35 a
M89#36 a
N88#38 c

J. Analysis of Financial Statements

M92#48 b
N91#17 b
M91#38 c
N90#10 b
M90#38 c
M89#37 d
N88#39 a
M88#38 c

K. Development Stage Enterprises

M92#49 a
N90# 8 b
M90#39 c
N89#38 a
M89#38 c
M88#39 c

L. Personal Financial Statements

M92#50 c
M91#40 b
N90# 9 c
M90#40 b
N89#39 c
M89#39 a
N88#40 c
M88#40 a

M. Combined Financial Statements

N91# 8 d
N90# 3 a
N89#40 c
M89#40 c

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

N91#41 c
M91#46 d
N90#41 a
M90#41 b
N89#41 c
M89#41 b
N88#41 c
M88#41 d

B. Process and Job Order Costing

M92#51 d
N91#43 b
M91#42 d
N90#42 c
M90#42 a
N89#42 a
N88#42 b
M88#42 a

C. Standard Costing

N91#42 c
M91#43 c
N90#43 b
M90#43 d
N89#43 c
N88#43 d
M88#43 b

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

N91#44 c
M91#41 a
M90#44 d
N89#44 c
M89#44 a
N88#44 a
M88#44 a

E. Absorption and Variable Costing

M92#52 c
N91#45 a
M91#45 b
N90#44 d
M90#45 d
N89#46 b
M89#45 c
N88#45 d
M88#45 d

F. Budgeting and Flexible Budgeting

M92#53 b
N91#46 c
M91#44 b
N90#45 a
M90#46 d
M89#46 a
N88#46 a
M88#46 b

G. Breakeven and Cost-Volume-Profit Analysis

M92#54 b
N91#47 a
M91#49 a
M90#47 c
N89#47 a
M89#47 b
N88#47 a
M88#47 c

H. Capital Budgeting Techniques

N91#49 d
M91#48 c
N90#46 b
N90#47 b
M90#48 d
N89#48 d
M89#48 c
N88#48 d
M88#48 b

I. Performance Analysis

M92#55 c
N91#50 b
M91#47 d
N90#48 d
M90#49 b
N89#49 c
M89#49 b
N88#49 a
M88#49 c

J. Other

M92#56 b
N91#48 a
M91#50 c
N90#49 c
N90#50 d
M90#50 c
N89#50 c
M89#50 a
N88#50 a

VIII. Not-for-Profit and Governmental Accounting

A. Conceptual Framework

M92#57 b
N91#51 a
M91#51 a
N90#51 a
M90#59 c
N89#51 d
M89#51 c
N88#51 c
M88#51 a

B. Fund Accounting

M92#58 d
N91#52 a
N91#53 b
M91#52 c
M91#53 c
M90#52 d
M90#54 b
N89#52 a
M89#52 a
M89#53 a
N88#53 c
M88#52 a
M88#53 b

C. Types of Funds and Account Groups

N91#54 d
N91#55 d
N91#56 c
N91#57 a
M91#54 c
M91#55 b
M91#56 d
M91#57 c
M91#58 a
N90#52 a
N90#53 c
N90#54 a
N90#55 b
N90#56 c
N90#57 d
N90#58 d
N90#59 d
M90#51 a
M90#53 d
M90#56 c
M90#57 d
N89#54 c
N89#55 a
N89#56 c
N89#57 d
M89#54 c
M89#55 b
M89#56 c
N88#54 a
N88#56 a
N88#57 b
M88#54 d
M88#55 a
M88#56 c
M88#57 a

D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

N91#58 c
M91#59 a
N90#60 b
M90#55 a
N89#60 d
M89#58 d
N88#58 a
M88#58 c

E. Various Types of Not-for-Profit and Governmental Organizations

M92#59 a
M92#60 d
N91#59 b
N91#60 d
M90#58 b
M90#60 b
N89#58 a
M89#59 d
M89#60 d
N88#60 a
M88#59 d

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OTHER OBJECTIVE ANSWER FORMATS — SELECTED QUESTIONS

VII. Cost Accumulation, Planning, and Control

C. Standard Costing

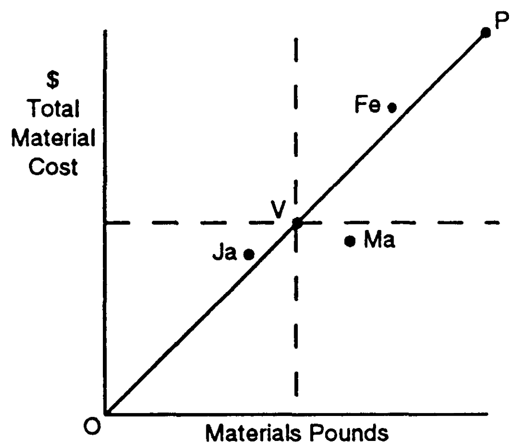
M92
Number 2 (Estimated time —— 15 to 25 minutes)

Instructions

Question Number 2 consists of 9 items.* Select the **best** answer for each item. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Answer all items.** Your grade will be based on the total number of correct answers.

Items 61 through 65 are based on the following:

Bilco Inc. produces bricks and uses a standard costing system. On the diagram below, the line OP represents Bilco's standard material cost at any output volume expressed in direct material pounds to be used. Bilco had identical outputs in each of the first three months of 1992, with a standard cost of V in each month. Points Ja, Fe, and Ma represent the actual pounds used and actual costs incurred in January, February, and March, respectively.



Required:
For Items 61 through 65, determine whether each variance is favorable (F) or unfavorable (U) and blacken the corresponding oval on the answer sheet.

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

Item

99. January material net variance.

Answer Sheet

Item	Variance
99	● (U)

*The items omitted can be found in Content Specification Area VIII.

Items to be Answered:

61. January material price variance.
62. January material usage variance.
63. February material price variance.
64. February material usage variance.
65. March material net variance.

VIII. Not-For-Profit and Governmental Accounting

C. Types of Funds and Account Groups

M92
Number 2 (cont.)

Instructions

Question Number 2 consists of 9 items.* Select the **best** answer for each item. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Answer all items.** Your grade will be based on the total number of correct answers.

Items 66 through 69 are based on the following:

During 1991, Krona City issued bonds for financing the construction of a civic center, and bonds for financing improvements in the environmental controls for its water and sewer enterprise. The latter bonds require a sinking fund for their retirement.

Required:
Financial Statement Items

Items 66 through 69 represent items Krona should report in its 1991 financial statements. For each item, determine whether it would be included in each of the fund types and account groups listed below. On the separate answer sheet, blacken (Y) if the item would be included and (N) if the item would not be included.

Krona's Fund Types and Account Groups:

A. General fund
B. Enterprise funds
C. Capital projects funds
D. Debt service funds
E. General fixed assets account group
F. General long-term debt account group

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

Item

99. Transfer of funds from the general fund to an enterprise fund.

Answer Sheet

	General Fund		Enterprise Funds		Capital Projects Funds		Debt Service Funds		General Fixed Assets Account Group		General Long-Term Debt Acct. Group	
Item	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
99	●	(N)	●	(N)	(Y)	●	(Y)	●	(Y)	●	(Y)	●

*The items omitted can be found in Content Specification Area VII.

M92
Number 2 (cont.)

Items to be Answered:

66. Bonds payable.
67. Accumulated depreciation.
68. Amounts identified for the repayment of the two bond issues.
69. Reserve for encumbrances.

VII. Cost Accumulation, Planning, and Control

C. Standard Costing

M92
Answer 2 (4 points)

ANSWER 2	Item	Variance	
	61	F	●
	62	●	U
	63	F	●
	64	F	●
	65	●	U

VIII. Not-For-Profit and Governmental Accounting

C. Types of Funds and Account Groups

M92
Answer 2 (6 points)

	General Fund		Enterprise Funds		Capital Projects Funds		Debt Service Funds		General Fixed Assets Account Group		General Long-Term Debt Acct. Group	
Item	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
66	Y	●	●	N	Y	●	Y	●	Y	●	●	N
67	Y	●	●	N	Y	●	Y	●	●	N	Y	●
68	Y	●	●	N	Y	●	●	N	Y	●	●	N
69	●	N	Y	●	●	N	Y	●	Y	●	Y	●

ESSAYS — SELECTED QUESTIONS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

M92
Number 4 (Estimated time —— 15 to 25 minutes)

On September 1, 1991, Plains Corp. acquired all of Sox Corp.'s outstanding stock for cash. The fair value of Sox's net assets was less than the purchase price but greater than the net carrying amount. During November 1991, Plains sold goods to Sox at a price that included its normal markup. At December 31, 1991, 20% of these goods remained in Sox's inventory. The separate legal entities were maintained and Sox uses push-down accounting for its separate financial statements.

Required:
Ignore income tax considerations when answering all questions.

a. 1. Specify three reasons for preparing consolidated financial statements that present operating results, cash flows, and financial position as if a parent company and its subsidiaries were a single entity.

2. What changes in Plains' September 1, 1991, consolidated balance sheet will result from this acquisition?

3. In preparing Plains' December 31, 1991, consolidated financial statements, what adjustments or eliminations are required as a consequence of the intercompany sales?

b. In preparing separate financial statements immediately after acquisition (September 1, 1991), what is the effect of the purchase on the balance sheet of:
1. Plains?
2. Sox (which uses push-down accounting)?

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

N91
Number 2 (Estimated time —— 15 to 25 minutes)

On September 30, 1989, Industrial Machinery Co. sold a machine and accepted the customer's noninterest-bearing note. Industrial normally makes sales on a cash basis. Since the machine was unique, its sales price was not determinable using Industrial's normal pricing practices.

After receiving the first of two equal annual installments on September 30, 1990, Industrial immediately discounted the note with recourse. On October 9, 1991, Industrial received notice that the note was dishonored, and it paid all amounts due. At all times prior to default, the note was reasonably expected to be paid in full.

Required:
a. 1. How should Industrial determine the sales price of the machine?

2. How should Industrial report the effects of the noninterest-bearing note on its income statement for the year ended December 31, 1989? Why is this accounting presentation appropriate?

b. What are the effects of the discounting of the note receivable with recourse on Industrial's income statement for the year ended December 31, 1990, and its balance sheet at December 31, 1990?

c. How should Industrial account for the effects of the note being dishonored?

N91
Number 3 (Estimated time —— 15 to 25 minutes)

Portland Co. uses the straight-line depreciation method for depreciable assets. All assets are depreciated individually except manufacturing machinery, which is depreciated by the composite method.

During the year, Portland exchanged a delivery truck with Maine Co. for a larger delivery truck. It paid cash equal to 10% of the larger truck's value.

Required:
a. What factors should have influenced Portland's selection of the straight-line depreciation method?

b. How should Portland account for and report the truck exchange transaction?

c. 1. What benefits should Portland derive from using the composite method rather than the individual basis for manufacturing machinery?

2. How should Portland have calculated the manufacturing machinery's annual depreciation expense in its first year of operation?

M91
Number 3 (Estimated time —— 15 to 25 minutes)

Happlia Co. imports expensive household appliances. Each model has many variations and each unit has an identification number. Happlia pays all costs for getting the goods from the port to its central warehouse in Des Moines. After repackaging, the goods are consigned to retailers. A retailer makes a sale, simultaneously buys the appliance from Happlia, and pays the balance due within one week.

To alleviate the overstocking of refrigerators at a Minneapolis retailer, some were reshipped to a Kansas City retailer where they were still held in inventory at December 31, 1990. Happlia paid the costs of this reshipment.

Happlia uses the specific identification inventory costing method.

Required:

a. In regard to the specific identification inventory costing method

1. Describe its key elements.
2. Discuss why it is appropriate for Happlia to use this method.

b. 1. What general criteria should Happlia use to determine inventory carrying amounts at December 31, 1990? Ignore lower of cost or market considerations.

2. Give four examples of costs included in these inventory carrying amounts.

c. What costs should be reported in Happlia's 1990 income statement? Ignore lower of cost or market considerations.

N90
Number 2 (Estimated time —— 15 to 25 minutes)

Since Grumer Co.'s inception, Monroe Co. has owned 18% of Grumer's outstanding common stock. Monroe provides three key management personnel to Grumer and purchased 25% of Grumer's output during 1989. Grumer is profitable. On January 2, 1990, Monroe purchased additional common stock to finance Grumer's expansion, thereby becoming a 30% owner. Grumer's common stock does not have a quoted market price. The stock has always been issued at its book value, which is assumed to approximate its fair value.

Required:

a. In general, distinguish between investor income reporting under the cost method and under the equity method. Which method is more consistent with accrual accounting? Why?

b. Prior to January 2, 1990, what specific factors should Monroe have considered in determining the appropriate method of accounting for its investment in Grumer?

c. For purposes of your answer to **c** only, assume Monroe used the cost method in accounting for its investment in Grumer prior to January 2, 1990. Describe the book adjustments required on January 2, 1990, when Monroe became owner of 30% of the outstanding common stock of Grumer.

M90
Number 2 (Estimated time —— 15 to 25 minutes)

Magrath Company has an operating cycle of less than one year and provides credit terms for all of its customers. On April 1, 1989, the company factored, without recourse, some of its accounts receivable.

On July 1, 1989, Magrath sold special order merchandise and received a noninterest-bearing note due June 30, 1991. The market rate of interest for this note is determinable.

Magrath uses the allowance method to account for uncollectible accounts. During 1989, some accounts were written off as uncollectible and other accounts previously written off as uncollectible were collected.

Required:

a. How should Magrath account for and report the accounts receivable factored on April 1, 1989? Why is this accounting treatment appropriate?

b. How should Magrath report the effects of the noninterest-bearing note on its income statement for the year ended December 31, 1989, and its December 31, 1989 balance sheet?

c. How should Magrath account for the collection of the accounts previously written off as uncollectible?

d. What are the two basic approaches to estimating uncollectible accounts under the allowance method? What is the rationale for each approach?

M90
Number 4 (Estimated time —— 15 to 25 minutes)

Huddell Company, which is both a wholesaler and retailer, purchases merchandise from various suppliers FOB destination, and incurs substantial warehousing costs.

The dollar value LIFO method is used for the wholesale inventories.

Huddell determines the estimated cost of its retail ending inventories using the conventional retail inventory method, which approximates lower of average cost or market.

Required:

a. When should the purchases from various suppliers generally be included in Huddell's inventory? Why?

b. How should Huddell account for the warehousing costs? Why?

c. 1. What are the advantages of using the dollar value LIFO method as opposed to the traditional LIFO method?

2. How does the application of the dollar value LIFO method differ from the application of the traditional LIFO method?

d. 1. In the calculation of the cost to retail percentage used to determine the estimated cost of its ending retail inventories, how should Huddell use

- Net markups?
- Net markdowns?

2. Why does Huddell's retail inventory method approximate lower of average cost or market?

N89
Number 2 (Estimated time —— 15 to 25 minutes)

Bristol Company purchased land as a site for construction of a factory. Outside contractors were engaged to:

- Construct the factory.
- Grade and pave a parking lot adjacent to the factory for the exclusive use of the factory workers.

Operations at the new location began during the year and normal factory maintenance costs were incurred after production began.

Required:

a. Distinguish between capital and revenue expenditures.

b. Indicate how expenditures for each of the following should be accounted for and reported by Bristol at the time incurred and in subsequent accounting periods.

1. Purchase of land.
2. Construction of factory.
3. Grading and paving parking lot.
4. Payment of normal factory maintenance costs.

Do not discuss capitalization of interest during construction in your response.

M89
Number 2 (Estimated time —— 15 to 25 minutes)

Vane Company has two portfolios of marketable equity securities. One is classified as a current asset, and the other is classified as a noncurrent asset. Vane does not have the ability to exercise significant influence over any of the companies in either portfolio. Some securities from each portfolio were sold during the year. One of the securities in the current portfolio was reclassified to the noncurrent portfolio when its market value was less than cost. At the beginning and end of the year, the aggregate cost of each portfolio exceeded its aggregate market value by different amounts.

Required:

a. How should Vane measure and report the income statement effects of the securities sold during the year from each portfolio?

b. How should Vane account for the security which was reclassified from the current asset portfolio to the noncurrent asset portfolio?

c. How should Vane report the effects of investments in each portfolio in its balance sheet as of the end of the year and its income statement for the year? Why? **Do not discuss the securities sold.**

M89
Number 3 (Estimated time —— 15 to 25 minutes)

Steel Company, a wholesaler that has been in business for two years, purchases its inventories from various suppliers. During the two years, each purchase has been at a lower price than the previous purchase.

Steel uses the lower of FIFO cost or market method to value inventories. The original cost of the inventories is above replacement cost and below the net realizable value. The net realizable value less the normal profit margin is below the replacement cost.

Required:

a. In general, what criteria should be used to determine which costs should be included in inventory?

b. In general, why is the lower of cost or market rule used to report inventory?

c. At what amount should Steel's inventories be reported on the balance sheet? Explain the application of the lower of cost or market rule in this situation.

d. What would have been the effect on ending inventories and net income for the second year had Steel used the lower of average cost or market inventory method instead of the lower of FIFO cost or market inventory method? Why?

N88
Number 2 (Estimated time —— 15 to 25 minutes)

Hogan Company uses the net method of accounting for sales discounts. Hogan also offers trade discounts to various groups of buyers.

On August 1, 1987, Hogan factored some accounts receivable on a without recourse basis. Hogan incurred a finance charge.

Hogan also has some notes receivable bearing an appropriate rate of interest. The principal and total interest are due at maturity. The notes were received on October 1, 1987, and mature on September 30, 1989. Hogan's operating cycle is less than one year.

Required:

a. 1. Using the net method, how should Hogan account for the sales discounts at the date of sale? What is the rationale for the amount recorded as sales under the net method?

2. Using the net method, what is the effect on Hogan's sales revenues and net income when customers do not take the sales discounts?

b. What is the effect of trade discounts on sales revenues and accounts receivable? Why?

c. How should Hogan account for the accounts receivable factored on August 1, 1987? Why?

d. How should Hogan report the effects of the interest-bearing notes receivable on its December 31, 1987, balance sheet and its income statement for the year ended December 31, 1987? Why?

N88
Number 3 (Estimated time —— 15 to 25 minutes)

At the beginning of the year, Patrick Company acquired a computer to be used in its operations. The computer was delivered by the supplier, installed by Patrick, and placed into operation. The estimated useful life of the computer is five years, and its estimated residual (salvage) value is significant.

During the year, Patrick received cash in exchange for an automobile that was purchased in a prior year.

Required:

a. 1. What costs should Patrick capitalize for the computer?

2. What is the objective of depreciation accounting? **Do not discuss specific methods of depreciation.**

b. What is the rationale for using accelerated depreciation methods?

c. How should Patrick account for and report the disposal of the automobile?

M88
Number 2 (Estimated time —— 15 to 25 minutes)

Hudson Company, which is both a wholesaler and a retailer, purchases its inventories from various suppliers.

Additional facts for Hudson's wholesale operations are as follows:

- Hudson incurs substantial warehousing costs.
- Hudson uses the lower of cost or market method.
- The replacement cost of the inventories is below the net realizable value and above the net realizable value less the normal profit margin. The original cost of the inventories is above the replacement cost and below the net realizable value.

Additional facts for Hudson's retail operations are as follows:

- Hudson determines the estimated cost of its ending inventories held for sale at retail using the conventional retail inventory method, which approximates lower of average cost or market.
- Hudson incurs substantial freight-in costs.
- Hudson has net markups and net markdowns.

Required:

a. Theoretically, how should Hudson account for the warehousing costs related to its wholesale inventories? Why?

b. 1. In general, why is the lower of cost or market method used to report inventory?

2. At which amount should Hudson's wholesale inventories be reported on the balance sheet? Explain the application of the lower of cost or market method in this situation.

c. In the calculation of the cost to retail percentage used to determine the estimated cost of its ending retail inventories, how should Hudson treat

1. Freight-in costs?
2. Net markups?
3. Net markdowns?

d. Why does Hudson's retail inventory method approximate lower of average cost or market?

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

M92
Number 3 (Estimated time —— 15 to 25 minutes)

Columbine Co.'s 10-year convertible bonds, issued and dated October 1, 1989, were common stock equivalents. Each $1,000 bond is convertible, at the holder's option, into 20 shares of Columbine's $25 par value common stock. The bonds were issued at a premium when the common stock traded at $45 per share. After payment of interest on October 1, 1991, 30% of the bonds were tendered for conversion when the common stock was trading at $57 per share. Columbine used the book value method to account for the conversion.

Required:
a. 1. How would the issue price of Columbine's convertible bonds be determined?
2. How should Columbine account for the issuance of the convertible bonds? Give the rationale for this accounting practice.
3. How should Columbine account for the conversion of the bonds into common stock?

b. 1. How should Columbine determine whether to include the convertible bonds, which are common stock equivalents, in computing 1989 primary earnings per share?
2. How does the inclusion of convertible bonds affect the computation of 1989 primary earnings per share?

N91
Number 4 (Estimated time —— 15 to 25 minutes)

Supey Chemical Co. encountered the following two situations in 1990:

- Supey must pay an indeterminate amount for toxic waste cleanup on its land. An adjoining land owner, Gap Toothpaste, sold its property because of possible toxic contamination by Supey of the water supply and resulting potential adverse public reaction towards its product. Gap sued Supey for damages. There is a reasonable possibility that Gap will prevail in the suit.

- At December 31, 1990, Supey had a noncancellable purchase contract for 10,000 pounds of Chemical XZ, for delivery in June 1991. Supey does not hedge its contracts. Supey uses this chemical to make Product 2-Y. In December 1990, the U.S. Food and Drug Administration banned the sale of Product 2-Y in concentrated form. Supey will be allowed to sell Product 2-Y in a diluted form; however, it will take at least five years to use the 10,000 pounds of Chemical XZ. Supey believes the sales price of the diluted product will not be sufficient to recover the contract price of Chemical XZ.

Required:
a. 1. In its 1990 financial statements, how should Supey report the toxic waste cleanup? Why is this reporting appropriate?
2. In its 1990 financial statements, how should Supey report Gap's claim against it? Why is this reporting appropriate?

b. In its 1990 financial statements, how should Supey report the effects of the contract to purchase Chemical XZ? Why is this reporting appropriate?

M91
Number 4 (Estimated time —— 15 to 25 minutes)

On December 31, 1989, Port Co. sold six-month old equipment at fair value and leased it back. There was a loss on the sale. Port pays all insurance, maintenance, and taxes on the equipment. The lease provides for eight equal annual payments, beginning December 31, 1990, with a present value equal to 85% of the equipment's fair value and sales price. The lease's term is equal to 80% of the equipment's useful life. There is no provision for Port to reacquire ownership of the equipment at the end of the lease term.

Required:
a. 1. Why is it important to compare an equipment's fair value to its lease payments' present value and its useful life to the lease term?
2. Evaluate Port's leaseback of the equipment in terms of each of the four criteria for determination of a capital lease.

b. How should Port account for the sale portion of the sale-leaseback transaction at December 31, 1989?

c. How should Port report the leaseback portion of the sale-leaseback transaction on its December 31, 1990, balance sheet?

M90
Number 3 (Estimated time —— 15 to 25 minutes)

On January 2, 1987, Drew Company issued 9% term bonds dated January 2, 1987, at an effective annual interest rate (yield) of 10%. Drew uses the effective interest method of amortization. On July 1, 1989, the bonds were extinguished early when Drew acquired them in the open market for a price greater than their face amount.

On September 1, 1989, Drew issued for cash 7% nonconvertible bonds dated September 1, 1989, with detachable stock purchase warrants. Immediately after issuance, both the bonds and the warrants had separately determined market values.

Required:

a. 1. Were the 9% term bonds issued at face amount, at a discount, or at a premium? Why?

2. Would the amount of interest expense for the 9% term bonds using the effective interest method of amortization be higher in the first or second year of the life of the bond issue? Why?

b. 1. How should gain or loss on early extinguishment of debt be determined? Does the early extinguishment of the 9% term bonds result in a gain or loss? Why?

2. How should Drew report the early extinguishment of the 9% term bonds on the 1989 income statement?

c. How should Drew account for the issuance of the 7% nonconvertible bonds with detachable stock purchase warrants?

N89
Number 3 (Estimated time 15 —— 25 minutes)

Chester Company has the following contingencies:

- A threat of expropriation exists for one of its manufacturing plants located in a foreign country. Expropriation is deemed to be reasonably possible. Any compensation from the foreign government would be less than the carrying amount of the plant.
- Potential costs exist due to the discovery of a safety hazard related to one of its products. These costs are probable and can be reasonably estimated.
- One of its warehouses located at the base of a mountain could no longer be insured against rock-slide losses. No rock-slide losses have occurred.

Required:

a. How should Chester report the threat of expropriation of assets? Why?

b. How should Chester report the potential costs due to the safety hazard? Why?

c. How should Chester report the noninsurable rock-slide risk? Why?

M89
Number 4 (Estimated time —— 15 to 25 minutes)

On January 2, 1988, Druid Company issued 9% term bonds dated January 2, 1988, at an effective interest rate (yield) of 10%. Druid uses the effective interest method of amortization.

On December 1, 1988, Druid issued 8% nonconvertible bonds dated December 1, 1988, with detachable stock purchase warrants. Immediately after issuance, both the bonds and the warrants have separately determined fair market values.

Required:

a. How would the issue price of the 9% bonds be determined?

b. 1. Were the 9% bonds issued at par, at a discount, or at a premium? Why?

2. Using the effective interest method of amortization, would the amount of interest expense for the 9% bonds be higher in the first year or second year? Why?

c. How should Druid account for the proceeds from the issuance of the 8% nonconvertible bonds with detachable stock purchase warrants? Why?

M89
Number 5 (Estimated time —— 15 to 25 minutes)

On January 1, 1988, Von Company entered into two noncancellable leases for new machines to be used in its manufacturing operations. The first lease does not contain a bargain purchase option; the lease term is equal to 80 percent of the estimated economic life of the machine. The second lease contains a bargain purchase option; the lease term is equal to 50 percent of the estimated economic life of the machine.

Required:

a. What is the theoretical basis for requiring lessees to capitalize certain long-term leases? **Do not discuss the specific criteria for classifying a lease as a capital lease.**

b. How should a lessee account for a capital lease at its inception?

c. How should a lessee record each minimum lease payment for a capital lease?

d. How should Von classify each of the two leases? Why?

N88
Number 4 (Estimated time —— 15 to 25 minutes)

Skinner Company has the following contingencies:

- Potential costs due to the discovery of a possible defect related to one of its products. These costs are probable and can be reasonably estimated.
- A potential claim for damages to be received from a lawsuit filed this year against another company. It is probable that proceeds from the claim will be received by Skinner next year.
- Potential costs due to a promotion campaign whereby a cash refund is sent to customers when coupons are redeemed. Skinner estimated, based on past experience, that 70 percent of the coupons would be redeemed. Forty percent of the coupons were actually redeemed and the cash refunds sent this year. The remaining 30 percent of the coupons are expected to be redeemed next year.

Required:

a. How should Skinner report the potential costs due to the discovery of a possible product defect? Why?

b. How should Skinner report this year the potential claim for damages that may be received next year? Why?

c. This year, how should Skinner account for the potential costs and obligations due to the promotion campaign?

M88

Number 4 (Estimated time —— 15 to 25 minutes)

On January 1, 1987, Metcalf Company sold equipment for cash and leased it back. As seller-lessee, Metcalf retained the right to substantially all of the remaining use of the equipment.

The term of the lease is eight years. There is a gain on the sale portion of the transaction. The lease portion of the transaction is classified appropriately as a capital lease.

Required:

a. What is the theoretical basis for requiring lessees to capitalize certain long-term leases? **Do not discuss the specific criteria for classifying a lease as a capital lease.**

b. 1. How should Metcalf account for the sale portion of the sale-leaseback transaction at January 1, 1987?

2. How should Metcalf account for the leaseback portion of the sale-leaseback transaction at January 1, 1987?

c. How should Metcalf account for the gain on the sale portion of the sale-leaseback transaction during the first year of the lease? Why?

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

M91

Number 5 (Estimated time —— 15 to 25 minutes)

Jay Co.'s 1990 consolidated financial statements include two wholly owned subsidiaries, Jay Co. of Australia (Jay A) and Jay Co. of France (Jay F). Functional currencies are the US dollar for Jay A and the franc for Jay F.

Required:

a. What are the objectives of translating a foreign subsidiary's financial statements?

b. How are gains and losses arising from translating or remeasuring of each subsidiary's financial statements measured and reported in Jay's consolidated financial statements?

c. FASB Statement No. 52 identifies several economic indicators that are to be considered both individually and collectively in determining the functional currency for a consolidated subsidiary. List three of those indicators.

d. What exchange rate is used to incorporate each subsidiary's equipment cost, accumulated depreciation, and depreciation expense in Jay's consolidated financial statements?

N90

Number 3 (Estimated time —— 15 to 25 minutes)

At December 31, 1989, Roko Co. has two fixed price construction contracts in progress. Both contracts have monthly billings supported by certified surveys of work completed. The contracts are:

- The Ski Park contract, begun in 1988, is 80% complete, is progressing according to bid estimates, and is expected to be profitable.
- The Nassu Village contract, a project to construct 100 condominium units, was begun in 1989. Thirty-five units have been completed. Work on the remaining units is delayed by conflicting recommendations on how to overcome unexpected subsoil problems. While the total cost of the project is uncertain, a loss is not anticipated.

Required:

a. Identify the alternatives available to account for long-term construction contracts, and specify the criteria used to determine which method is applicable to a given contract.

b. Identify the appropriate accounting method for each of Roko's two contracts, and describe each contract's effect on net income for 1989.

c. Indicate how the accounts related to the Ski Park contract should be reported on the balance sheet at December 31, 1989.

N90

Number 4 (Estimated time —— 15 to 25 minutes)

Clonal, Inc., a biotechnology company, developed and patented a diagnostic product called Trouver.

Clonal purchased some research equipment to be used exclusively for Trouver and other research equipment to be used on Trouver and subsequent research projects. Clonal defeated a legal challenge to its Trouver patent, and began production and marketing operations for the product.

Corporate headquarters' costs were allocated to Clonal's research division as a percentage of the division's salaries.

Required:

a. How should the equipment purchased for Trouver be reported in Clonal's income statements and balance sheets?

b. 1. Describe the matching principle.

2. Describe the accounting treatment of research and development costs and consider whether this is consistent with the matching principle. What is the justification for the accounting treatment of research and development costs?

c. How should corporate headquarters' costs allocated to the research division be classified in Clonal's income statement? Why?

d. How should the legal expenses incurred in defending Trouver's patent be reported in Clonal's statement of cash flows (direct method)?

M90
Number 5 (Estimated time —— 15 to 25 minutes)

Boulder Company appropriately changed its depreciation method for its production machinery from the double-declining balance method to the production method effective January 1, 1989.

In addition, effective January 1, 1989, Boulder appropriately changed the salvage values used in computing depreciation for its office equipment.

On December 31, 1989, Boulder appropriately changed the specific subsidiaries constituting the group of companies for which consolidated financial statements are presented.

Required:

a. Identify any accounting changes in the three situations described above. For each accounting change identified, indicate whether Boulder should show:

- The cumulative effect of a change in accounting principle in net income of the period of change.
- Pro forma effects of retroactive application for all prior periods presented currently.
- Restatement of the financial statements of all prior periods presented currently.

b. 1. Why are accounting principles, once adopted, normally continued?

2. What is the rationale for disclosure of a change from one generally accepted accounting principle to another generally accepted accounting principle?

N89
Number 4 (Estimated time —— 15 to 25 minutes)

Essex Company has a single-employer defined benefit pension plan, and a compensation plan for future vacations for its employees.

Required:

a. Define the interest cost component of net pension cost for a period. How should Essex determine its interest cost component of net pension cost for a period?

b. Define prior service cost. How should Essex account for prior service cost? Why?

c. What conditions must be met for Essex to accrue compensation for future vacations? What is the theoretical rationale for accruing compensation for future vacations?

N89
Number 5 (Estimated time —— 15 to 25 minutes)

Hillside Company had a loss during the year ended December 31, 1988 that is properly reported as an extraordinary item.

On July 1, 1988, Hillside committed itself to a formal plan for sale of a business segment. A loss is expected from the proposed sale. Segment operating losses were incurred continuously throughout 1988, and were expected to continue until final disposition in 1989. Costs were incurred in 1988 to relocate segment employees.

Required:

a. How should Hillside report the extraordinary item in its income statement? Why?

b. How should Hillside report the effect of the discontinued operations in its 1988 income statement?

c. How should Hillside report the costs that were incurred to relocate employees of the discontinued segment? Why?

Do not discuss earnings per share requirements.

M88
Number 3 (Estimated time —— 15 to 25 minutes)

There are various types of accounting changes, each of which is required to be reported differently.

Required:

a. What type of accounting change is a change from the sum-of-the-years'-digits method of depreciation to the straight-line method for previously recorded assets? Under what circumstances does this type of accounting change occur?

b. What type of accounting change is a change in the expected service life of an asset arising because of more experience with the asset? Under what circumstances does this type of accounting change occur?

c. With respect to a change in accounting principle,

1. How should a company calculate the effect?
2. How should a company report the effect?

Do not discuss earnings per share requirements.

d. 1. Why are accounting principles, once adopted, normally continued?

2. What is the rationale for disclosure of a change from one accounting principle to another accounting principle?

M88

Number 5 (Estimated time —— 15 to 25 minutes)

Carson Company sponsors a single-employer defined benefit pension plan. The plan provides that pension benefits are determined by age, years of service, and compensation. Among the components that should be included in the net pension cost recognized for a period are service cost, interest cost, and actual return on plan assets.

Required:

a. What two accounting problems result from the nature of the defined benefit pension plan? Why do these problems arise?

b. How should Carson determine the service cost component of the net pension cost?

c. How should Carson determine the interest cost component of the net pension cost?

d. How should Carson determine the actual return on plan assets component of the net pension cost?

VI. Other Financial Topics

M92

Number 5 (Estimated time —— 15 to 25 minutes)

At December 31, 1991, as a result of its single employer defined benefit pension plan, Bighorn Co. had an unrecognized net loss and an unfunded accrued pension cost. Bighorn's pension plan and its actuarial assumptions have not changed since it began operations in 1987. Bighorn has made annual contributions to the plan.

Required:

a. Identify the components of net pension cost that should be recognized in Bighorn's 1991 financial statements.

b. What circumstances caused Bighorn's

1. Unrecognized net loss?
2. Unfunded accrued pension cost?

c. How should Bighorn compute its minimum pension liability and any additional pension liability?

N91

Number 5 (Estimated time —— 15 to 25 minutes)

Barnet Co. has several reportable industry segments that account for 90% of its operations. It has no foreign operations, sales, or major individual customers. On August 1, 1991, Barnet signed a formal agreement to sell its boating segment for considerably less than its carrying amount. Small profits were realized on the boating segment throughout 1991 and are expected to continue until final disposition on February 28, 1992. The sum of the 1991 and 1992 boating profits is expected to be less than the disposal loss.

Required:

a. What is the purpose of segment disclosure?

b. What tests should Barnet apply in determining its reportable segments?

c. How should Barnet report discontinued boating operations on its 1991 income statement?

M91

Number 2 (Estimated time —— 15 to 25 minutes)

Pap Co. and Sib Co. plan to combine on December 31, 1990, with Sib becoming Pap's subsidiary. Pap's $1 par value common stock will be exchanged, on a 3 for 1 basis, for the majority of Sib's outstanding $1 par value common stock. Johnson continues to hold a minority interest in Sib. There is neither treasury stock nor intercompany holdings. Both companies use the same accounting methods and practices, and have net assets with fair values in excess of carrying amounts. Ignore any expense connected with the combination.

Required:

a. What is the conceptual rationale used to account for a business combination as a pooling of interests? Do **not** discuss accounting entries or specific criteria required for applying pooling-of-interests accounting.

b. What percentage of Sib's outstanding common stock must be exchanged at December 31, 1990, so that pooling-of-interests accounting is used for the combination?

c. If pooling-of-interests accounting is used, how should the December 31, 1990, consolidated balance sheet report:

1. Assets and liabilities?
2. Investors' interests?

N90
Number 5 (Estimated time —— 15 to 25 minutes)

On November 5, 1986, Gunpowder Corp.'s board of directors approved a stock option plan for key executives. On January 2, 1987, a specific number of stock options were granted. These options were exercisable between January 2, 1989, and December 31, 1991, at 90% of the quoted market price on January 2, 1987. The service period is for 1987 and 1988. Some options were forfeited when an executive resigned in 1988. All other options were exercised during 1989.

Required:

a. When is Gunpowder's stock option measurement date? Why?

b. How should Gunpowder determine the compensation expense, if any, for the stock option plan in 1987?

c. What is the effect of forfeiture of the stock options on Gunpowder's financial statements for 1988? Why?

d. What is the effect of the stock option plan on the balance sheet at December 31, 1989? Be specific as to the changes in balance sheet accounts between November 5, 1986, and December 31, 1989.

N88
Number 5 (Estimated time —— 15 to 25 minutes)

There are two methods of accounting for business combinations, purchase and pooling of interests.

Required:

a. 1. What is the rationale for accounting for a business combination as a purchase? **Do not discuss the specific criteria for accounting for a business combination as a purchase.**

2. In a business combination accounted for as a purchase, how should the amount of goodwill at acquisition be determined?

3. In a business combination accounted for as a purchase, how should goodwill be amortized?

b. 1. What is the rationale for accounting for a business combination as a pooling of interests? **Do not discuss the specific criteria for accounting for a business combination as a pooling of interests.**

2. In a business combination accounted for as a pooling of interests, when both companies use the same methods of accounting, how should the stockholders' equity be accounted for?

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

M92
Answer 4 (10 points)

a. 1. Consolidated operating results, cash flows, and financial position are prepared, as if a parent company and its subsidiaries are a single entity, to provide information that:

- Reflects the operating results, financial status, and central management ties that bind the companies into a single economic and financial unit.
- Is representationally faithful and fair, without the biases caused by exclusions or netting of data.
- Is comparable with information about other economic entities regardless of the companies' legal framework.
- Is relevant and complete for investors and other parties basing decisions on the data.

2. Plains' September 1, 1991, consolidated balance sheet is changed by including all of Sox's identifiable assets and liabilities at their fair values, and cash is decreased by the purchase price. The excess of purchase price over the fair value of the net assets acquired is reported as goodwill.

3. The effect of the intercompany sales is eliminated from Plains' December 31, 1991, consolidated financial statements by:

- Reducing sales by the amount of the intercompany sales.
- Reducing ending inventory by the markup on goods sold by Plains and still held by Sox.
- Reducing cost of goods sold for the difference between the amounts of the two previous adjustments.

b. 1. The effects on Plains' September 1, 1991, balance sheet, are the establishment of an investment in Sox and a decrease in cash equal to the purchase price.

2. Using push-down accounting, all of Sox's assets and liabilities, including goodwill, are restated to reflect their fair values on September 1, 1991. The retained earnings balance is eliminated. Additional paid-in capital is adjusted for the difference arising from the restatement of the asset and liability balances and the elimination of retained earnings.

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

N91
Answer 2 (10 points)

a. 1. It was not possible to determine the machine's fair value directly, so the sales price of the machine is reported at the note's September 30, 1989, fair value. The note's September 30, 1989, fair value equals the present value at that date of the two installments discounted at the buyer's September 30, 1989, market rate of interest from their due dates of September 30, 1990, and September 30, 1991.

2. Industrial reports 1989 interest revenue determined by multiplying the note's carrying amount at September 30, 1989, times the buyer's market rate of interest at the date of issue, times three-twelfths. Industrial should recognize that there is an interest factor implicit in the note, and this interest is earned with the passage of time. Therefore, interest revenue for 1989 should include three months' revenue. The rate used should be the market rate established by the original present value, and this is applied to the carrying amount of the note.

b. To report the discounting of the note receivable with recourse, Industrial should decrease notes receivable by the carrying amount of the discounted note, increase cash by the amount received, and report the difference as a loss or gain as part of income from continuing operations. The contingent liability with respect to a possible customer default should be disclosed in notes to the financial statements.

c. Industrial should decrease cash, and increase its notes (accounts) receivable past due for all payments caused by the note's dishonor. The note (account) receivable should be written down to its estimated recoverable amount (or an allowance for uncollectibles established), and a loss on uncollectible notes should be recorded for the difference.

N91

Answer 3 (10 points)

a. Portland should have selected the straight-line depreciation method when approximately the same amount of an asset's service potential is used up each period. If the reasons for the decline in service potential are unclear, then the selection of the straight-line method could be influenced by the ease of recordkeeping, its use for similar assets, and its use by others in the industry.

b. Portland should record depreciation expense to the date of the exchange. If the original truck's carrying amount is greater than its fair value, a loss results. The truck's capitalized cost and accumulated depreciation are eliminated, and the loss on trade-in is reported as part of income from continuing operations. The newly acquired truck is recorded at fair value. If the original truck's carrying amount is less than its fair value at trade-in, then there is an unrecognized gain. The newly acquired truck is recorded at fair value less the unrecognized gain. Cash is decreased by the amount paid.

c. 1. By associating depreciation with a group of machines instead of each individual machine, Portland's bookkeeping process is greatly simplified. Also, since actual machine lives vary from the average depreciable life, unrecognized net losses on early dispositions are expected to be offset by continuing depreciation on machines usable beyond the average depreciable life. Periodic income does not fluctuate as a result of recognizing gains and losses on manufacturing machine dispositions.

2. Portland should divide the depreciable cost (capitalized cost less residual value) of each machine by its estimated life to obtain its annual depreciation. The sum of the individual annual depreciation amounts should then be divided by the sum of the individual capitalized costs to obtain the annual composite depreciation rate.

M91

Answer 3 (10 points)

a. 1. The specific identification method requires each unit to be clearly distinguished from similar units either by description, identification number, location, or other characteristic. Costs are accumulated for specific units and expensed as the units are sold. Thus, the specific identification method results in recognized cost flows being identical to actual physical flows. Ideally, each unit is relatively expensive and the number of such units relatively few so that recording of costs is not burdensome. Under the specific identification method, if similar items have different costs, cost of goods sold is influenced by the specific units sold.

2. It is appropriate for Happlia to use the specific identification method because each appliance is expensive, and easily identified by number and description. The specific identification method is feasible because Happlia already maintains records of its units held by individual retailers. Management's ability to manipulate cost of goods sold is minimized because once the inventory is in retailer's hands Happlia's management cannot influence the units selected for sales.

b. 1. Happlia should include in inventory carrying amounts all necessary and reasonable costs to get an appliance into a useful condition and place for sale. Common (or joint) costs should be allocated to individual units. Such costs exclude the excess costs incurred in transporting refrigerators to Minneapolis and their reshipment to Kansas City. These units costs should only include normal freight costs from Des Moines to Kansas City. In addition, costs incurred to provide time utility to the goods, i.e., ensuring that they are available when required, will also be included in inventory carrying amounts.

2. Examples of inventoriable costs include the unit invoice price, plus an allocated proportion of the port handling fees, import duties, freight costs to Des Moines and to retailers, insurance costs, repackaging, and warehousing costs.

c. The 1990 income statement should report in cost of goods sold all inventory costs related to units sold in 1990, regardless of when cash is received from retailers. Excess freight costs incurred for shipping the refrigerators from Minneapolis to Kansas City should be included in determining operating income.

N90

Answer 2 (10 points)

a. Under the cost method, the investor recognizes dividends as income when received. Under the equity method, an investor recognizes as income its share of an investee's earnings or losses in the periods in which they are reported by the investee. The amount recognized as income is adjusted for any change in the difference between investment cost and underlying equity in net assets at the investment date. The equity method is more consistent with accrual accounting than is the cost method, because the equity method recognizes income when earned rather than when dividends are received.

b. Monroe should have assessed whether it could have exerted significant influence over Grumer's operating and financial policies. Monroe did not own 20% or more of Grumer's voting stock (which would have given the refutable presumption that it could exercise significant influence); however, the ability to exercise significant influence may be indicated by other factors such as Monroe's provision of three key management personnel and purchase of 25% of Grumer's output.

c. On becoming a 30% owner of Grumer, Monroe should use the equity method to account for its investment. As of January 2, 1990, Monroe's investment and retained earnings accounts must be adjusted retroactively to show balances as if the equity method had been used from the initial purchase date. Both accounts should be increased by 18% of Grumer's undistributed income since formation. [In this case, no adjustment to the undistributed income is necessary since the stock was issued at its book value which was assumed to approximate its fair value.]

M90
Answer 2 (10 points)

a. To account for the accounts receivable factored on April 1, 1989, Magrath should decrease accounts receivable by the amount of accounts receivable factored, increase cash by the amount received from the factor, and record a loss equal to the difference. The loss should be reported in the income statement. Factoring of accounts receivable on a without recourse basis is equivalent to a sale.

b. The carrying amount of the note at July 1, 1989 is the maturity amount discounted for two years at the market interest rate. For the noninterest-bearing note receivable, the interest revenue for 1989 should be determined by multiplying the carrying amount of the note at July 1, 1989 times the market rate of interest at the date of the note times one-half.

The noninterest-bearing note receivable should be reported in the December 31, 1989 balance sheet, as a noncurrent asset at its face amount less the unamortized discount.

c. Magrath should account for the collection of the accounts previously written off as uncollectible as follows:

- Increase both accounts receivable and the allowance for uncollectible accounts.
- Increase cash and decrease accounts receivable.

d. One approach estimates uncollectible accounts based on credit sales. This approach focuses on income determination by attempting to match uncollectible accounts expense with the revenues generated.

The other allowance approach estimates uncollectible accounts based on the balance in or aging of receivables. The approach focuses on asset valuation by attempting to report receivables at realizable value.

M90
Answer 4 (10 points)

a. Purchases from various suppliers generally should be included in Huddell's inventory when Huddell receives the goods. Title to goods purchased FOB destination is assumed to pass when the goods are received.

b. Huddell should account for the warehousing costs as additional cost of inventory. All necessary and reasonable costs of readying goods for sale should be included in inventory.

c. 1. The advantages of using the dollar value LIFO method are to reduce the cost of accounting for inventory and to minimize the probability of reporting the liquidation of LIFO inventory layers.

2. The application of dollar value LIFO is based on dollars of inventory, an inventory cost index for each year, and broad inventory pools. The inventory layers are identified with the inventory cost index for the year in which the layer was added. In contrast, traditional LIFO is applied to individual units at their cost.

d. 1. Huddell's net markups should be included only in the retail amounts (denominator) to determine the cost to retail percentage.

Huddell's net markdowns should be ignored in the calculation of the cost to retail percentage.

2. By not deducting net markdowns from the retail amounts to determine the cost to retail percentage, Huddell produces a lower cost to retail percentage than would result if net markdowns were deducted. Applying this lower percentage to ending inventory at retail, the inventory is reported at an amount below cost. This amount is intended to approximate lower of average cost or market.

N89
Answer 2 (10 points)

a. Capital expenditures benefit future periods. Revenue expenditures benefit the current period only.

b. 1. The purchase price of the land should be capitalized. The land should be shown as a noncurrent asset on the balance sheet at its original cost and it is not subject to depreciation.

2. The cost of constructing the factory should be capitalized and depreciated over the expected life of the factory. The depreciation should be added to cost of inventory, via factory overhead, as goods are produced, and is expensed as cost of sales as goods are sold. The factory expenditures, net of accumulated depreciation, should be shown as a noncurrent asset on the balance sheet. Inventory should be reported as a current asset on the balance sheet, and cost of sales should be reported as an expense on the income statement.

3. The cost of grading and paving the parking lot should be capitalized and depreciated over the expected life of either the factory or parking lot, whichever is shorter. The depreciation should be added to cost of inventory, via factory overhead, as goods are produced, and is expensed as cost of sales as goods are sold. The land improvement expenditures, net of accumulated depreciation, should be shown as a noncurrent asset on the balance sheet. Inventory should be reported as a current asset on the balance sheet, and

cost of sales should be reported as an expense on the income statement.

4. The cost of maintaining the factory once production has begun is a "revenue type" expenditure. However, since it is a factory cost, it should be added to cost of inventory, via factory overhead, as goods are produced, and is expensed as cost of sales as goods are sold. Inventory should be reported as a current asset on the balance sheet, and cost of sales should be reported as an expense on the income statement.

M89

Answer 2 (10 points)

a. The differences between the selling prices and the costs of securities sold should be reported as realized gains and losses in the determination of net income.

b. The security in the current portfolio should be reclassified to the noncurrent portfolio at the lower of its cost or market value at the date of reclassification. Since its market value was less than cost, the market value becomes the new cost basis. The excess of cost over market value at the date of reclassification should be reported as a realized loss in the determination of net income.

c. Each portfolio should be reported in the balance sheet at its separately determined lower of aggregate cost or market value. Applying this rule, Vane would report each portfolio at market by using a valuation allowance (contra) account for the excess of aggregate cost over aggregate market value.

For the current portfolio, the change in the valuation allowance (contra) account that occurred during the year should be reported as an unrealized gain or loss in the income statement. For the noncurrent portfolio, an amount equal to the valuation allowance (contra) account balance should be reported separately in the equity section of the balance sheet.

Reporting the portfolio at market value reflects the realizable value of the portfolio at the end of the period and is consistent with conservatism. For the current portfolio, the estimated loss is reported (matched) in the income statement in the period in which the change in realizable value occurred. Reporting the current portfolio at market indicates the expected cash flow from the sale of the securities. Inclusion of the reduction in market value of the current portfolio in net income assists in cash flow projections by acknowledging the expected impairment in future cash flows as a consequence of the investment. For the noncurrent portfolio, the decline in market value (loss) is less certain of realization in the near term, and may not be a reasonable estimate of the cash flow consequence of the investment. Therefore, changes in market value of the noncurrent portfolio are not considered useful for cash flow projections.

M89

Answer 3 (10 points)

a. Inventory cost should include all reasonable and necessary costs of preparing inventory for sale. These costs include not only the purchase price of the inventories, but also other costs associated with readying inventories for sale.

b. The lower of cost or market rule produces a realistic estimate of future cash flows to be realized from the sale of inventories. This is consistent with the principle of conservatism, and recognizes (matches) the anticipated loss in the income statement in the period in which the price decline occurs.

c. Steel's inventories should be reported on the balance sheet at market. According to the lower of cost or market rule, market is defined as replacement cost. Market cannot exceed net realizable value and cannot be less than net realizable value less the normal profit margin. In this instance, replacement cost is between net realizable value and net realizable value less the normal profit margin. Therefore, market is established as replacement cost. Since market is less than original cost, inventory should be reported at market.

d. Ending inventories and net income would have been the same under either lower of average cost or market or lower of FIFO cost or market. In periods of declining prices, the lower of cost or market rule results in a write-down of inventory cost to market under both methods, resulting in the same inventory cost. Therefore, net income using either inventory method is the same.

N88

Answer 2 (10 points)

a. 1. Hogan should account for the sales discounts at the date of sale using the net method by recording accounts receivable and sales revenue at the amount of sales less the sales discounts available.

Revenues should be recorded at the cash equivalent price at the date of sale. Under the net method, the sale is recorded at an amount that represents the cash equivalent price at the date of exchange (sale).

2. There is no effect on Hogan's sales revenues when customers do not take the sales discounts. Hogan's net income is increased by the amount of interest (discount) earned when customers do not take the sales discounts.

b. Trade discounts are neither recorded in the accounts nor reported in the financial statements. Therefore, the amount recorded as sales revenues and accounts receivable is net of trade discounts and represents the cash equivalent price of the asset sold.

c. To account for the accounts receivable factored on August 1, 1987, Hogan should decrease accounts receivable by the amount of accounts receivable factored, increase cash by the amount received from the factor, and record a loss. Factoring of accounts receivable on a without recourse basis is equivalent to a sale. The difference between the cash received and the carrying amount of the receivables is a loss.

d. Hogan should report the face amount of the interest-bearing notes receivable and the related interest receivable for the period from October 1 through December 31 on its balance sheet as noncurrent assets. Both assets are due on September 30, 1989, which is more than one year from the date of the balance sheet.

Hogan should report interest revenue from the notes receivable on its income statement for the year ended December 31, 1987. Interest revenue is equal to the amount accrued on the notes receivable at the appropriate rate for three months.

Interest revenue is realized with the passage of time. Accordingly, interest revenue should be accounted for as an element of income over the life of the notes receivable.

N88
Answer 3 (10 points)

a. 1. The capitalized cost for the computer includes all costs reasonable and necessary to prepare it for its intended use. Examples of such costs are the cash purchase price, delivery, installation, testing, and set up.

2. The objective of depreciation accounting is to allocate the depreciable cost of an asset over its estimated useful life in a systematic and rational manner. This process matches the depreciable cost of the asset with revenues generated from its use. Depreciable cost is the capitalized cost less its estimated residual (salvage) value.

b. The rationale for using accelerated depreciation methods is based on the following assumptions:

- An asset is more productive in the earlier years of its estimated useful life. Therefore, larger depreciation charges in the earlier years would be matched against the larger revenues generated in the earlier years.
- An asset may become technologically obsolete prior to the end of its originally estimated useful life. The risk associated with estimated long-term cash flows is greater than the risk associated with near-term cash flows. Accelerated depreciation recognizes this condition.

c. Patrick should record depreciation expense to the date of disposal. Recording depreciation updates the carrying amount of the automobile. If the carrying amount of the automobile (capitalized cost less accumulated depreciation) differs from the cash proceeds from the disposal, a gain or loss results. Patrick should report gain or loss on disposal as part of income from continuing operations.

M88
Answer 2 (10 points)

a. Hudson should account for the warehousing costs related to its wholesale inventories as part of inventory. All reasonable and necessary costs of preparing inventory for sale should be recorded as inventory cost. This approach results in proper matching of the warehousing costs with revenue when the wholesale inventories are sold.

b. 1. The lower of cost or market method produces a more realistic estimate of future cash flows to be realized from assets, which is consistent with the principle of conservatism, and recognizes (matches) the anticipated loss in the income statement in the period in which the price decline occurs.

2. Hudson's wholesale inventories should be reported on the balance sheet at replacement cost. According to the lower of cost or market method, replacement cost is defined as market. However, market cannot exceed net realizable value and cannot be less than net realizable value less the normal profit margin. In this instance, replacement cost is below original cost, below net realizable value, and above net realizable value less the normal profit margin. Therefore, Hudson's wholesale inventories should be reported at replacement cost.

c. 1. Hudson's freight-in costs should be included only in the cost amounts to determine the cost to retail percentage.

2. Hudson's net markups should be included only in the retail amounts to determine the cost to retail percentage.

3. Hudson's net markdowns should not be deducted from the retail amounts to determine the cost to retail percentage.

d. By not deducting net markdowns from the retail amounts to determine the cost to retail percentage, Hudson produces a lower cost to retail percentage than would result if net markdowns were deducted. By applying this lower percentage to ending inventory at retail, the inventory is reported at an amount below cost, which approximates lower of average cost or market.

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

M92

Answer 3 (10 points)

a. 1. The bond issue price would be determined by the expected future cash flows of principal and interest, discounted at the market rate of interest, plus the value of the conversion option at the date of issuance.

2. Columbine should account for the issuance of the convertible bonds by increasing cash for the issue price, increasing bonds payable by the face amount, and increasing premium on bonds payable for the balance. The convertible debt is accounted for solely as debt. The conversion option is not recognized primarily because it is inseparable from the debt, and secondarily because of the practical difficulty of assigning it a value.

3. Columbine should account for the conversion of the bonds into common stock by decreasing both bonds payable and unamortized bond premium by 30%, increasing common stock by $25 for each share issued, and increasing additional paid-in capital by the difference between the three previous amounts.

b. 1. If the bonds are dilutive, they are included in computing Columbine's 1989 primary earnings per share.

2. Both earnings and number of shares are affected by including the convertible bonds in computing primary earnings per share. Interest expense on convertible bonds, net of income taxes, is added to net income. The number of shares outstanding is increased by the number of shares potentially issuable on conversion (number of bonds times 20), multiplied by the proportion of the year that the bonds were outstanding (one-quarter).

N91

Answer 4 (10 points)

a. 1. Notes to Supey's 1990 financial statements should disclose the nature of the loss on cleanup and indicate that an estimate of the loss, or range of the loss, cannot be made. No accrual should be made because the loss cannot be reasonably estimated and accrual of an uncertain amount would impair the integrity of the financial statements.

2. Supey should disclose the nature of Gap's claim in the notes to the 1990 financial statements. Disclosure should include an estimate of the potential loss. Supey should not accrue the loss because it is only reasonably possible that it will have to pay for Gap's losses.

b. An estimated loss on the purchase commitment, equal to the unrecoverable amount of the contract price, should be reported as part of 1990 income from continuing operations and as a current liability at December 31, 1990. The net loss on the purchase commitment should be measured and recognized in the period in which it occurs. Since Supey did not hedge this contract, reporting this loss recognizes the commitment's impact on future cash flows.

M91

Answer 4 (10 points)

a. 1. Comparisons of an equipment's fair value to its lease payments' present value, and of its useful life to the lease term, are used to determine whether the lease is equivalent to an installment sale, and therefore is a capital lease.

2. A lease is categorized as a capital lease, if, at the date of the lease agreement, it meets any one of four criteria. As the lease has no provision for Port to reacquire ownership of the equipment, it fails the two criteria of transfer of ownership at the end of the lease and a bargain purchase option. Port's lease payments, with a present value equaling 85% of the equipment's fair value, fail the criterion for a present value equaling or exceeding 90% of the equipment's fair value. However, the lease would be classified as a capital lease, because its term of 80% of the equipment's estimated useful life exceeds the criterion of being at least 75% of the equipment's estimated useful life.

b. Port should account for the sale portion of the sale-leaseback transaction at December 31, 1989, by increasing cash for the sale price, decreasing equipment by the carrying amount, and recognizing a loss for the excess of the equipment's carrying amount over its sale price.

c. On the December 31, 1990, balance sheet, the equipment should be included as a fixed asset, at the lease payments' present value at December 31, 1989, less 1990 amortization.

On the December 31, 1990, balance sheet, the lease obligation will equal the lease payments' present value at December 31, 1989, less principal repaid December 31, 1990. This amount will be reported in current liabilities for the principal to be repaid in 1991, and the balance in noncurrent liabilities.

M90

Answer 3 (10 points)

a. 1. The 9% bonds were issued at a discount (less than face amount). Although the bonds provide for payment of interest of 9% of face amount, this rate was less than the prevailing or market rate for bonds of similar quality at the time the bonds were issued. Thus, the issue price of the bonds, which is the present value of the principal and interest payments discounted at 10%, is less than the face amount.

2. The amount of interest expense would be higher in the second year of the life of the bond issue than in the first year of the life of the bond issue. According to the effective interest method of amortiza-

tion, the 10% effective interest rate is applied to the bond carrying amount. In a discount situation, the bond carrying amount increases each year, and this results in a greater interest expense in each successive year.

b. 1. Gain or loss on early extinguishment of debt should be determined by comparing the carrying amount of the bonds at the date of extinguishment with the acquisition price. If the carrying amount exceeds the acquisition price, a gain results. If the carrying amount is less than the acquisition price, a loss results.

In this case, a loss results. The term bonds were issued at a discount. Therefore, the carrying amount of the bonds at the date of extinguishment must be less than the face amount, which is less than the acquisition price.

2. Drew should report the loss from early extinguishment of debt in its 1989 income statement as an extraordinary item, net of income taxes.

c. The proceeds from the issuance of the 7% nonconvertible bonds with detachable stock purchase warrants should be recorded as an increase in cash. These proceeds should be allocated between the bonds and the warrants on the basis of their relative market values. The portion of the proceeds allocable to the bonds should be accounted for as long-term debt, while the portion allocable to the warrants should be accounted for as paid-in capital.

N89

Answer 3 (10 points)

a. Chester should disclose the threat of expropriation of assets in the notes to the financial statements. Disclosure would include an estimate of the possible loss or an estimate of the range of loss. Accrual of a loss is inappropriate because the threat of expropriation is only reasonably possible.

b. Chester should report the potential costs due to the safety hazard by accruing a loss in the income statement and a liability in the balance sheet. Accrual is required because both of the following conditions are met:

- It is considered probable that a liability has been incurred.
- The amount of the loss can be reasonably estimated.

In addition, Chester should separately disclose in the notes to the financial statements the nature of the safety hazard.

c. Chester should not accrue a loss because an asset has not been impaired nor has a liability been incurred. Disclosure of the uninsured rock-slide risk, while permitted, is not required.

M89

Answer 4 (10 points)

a. The issue price of the bond is determined by calculating the present value of all expected future cash outflows discounted at the effective interest rate (yield) of 10%. The issue price is the sum of the present value of the bonds' maturity amount (face value) plus the present value of the series of future interest payments.

b. 1. The 9% bonds were issued at a discount (less than face value). Although the bonds provide for the payment of interest at 9% of face value, 9% was less than the prevailing or market rate. Thus, in order to provide a yield of 10% to investors, the bonds must have been issued at a discount.

2. The amount of interest expense would be higher in the second year than in the first year. According to the effective interest method of amortization, the 10% effective interest rate is applied to an increasing bond carrying amount, which results in a higher interest expense in each successive year.

c. The proceeds from the issuance of the 8% nonconvertible bonds with detachable stock purchase warrants should be allocated between the bonds and the warrants on the basis of their relative fair market values. The portion of the proceeds allocable to the bonds should be accounted for as long-term debt, while the portion allocable to the warrants should be accounted for as paid-in capital.

M89

Answer 5 (10 points)

a. The economic effects of a long-term capital lease on the lessee are similar to that of an equipment purchase using installment debt. Such a lease transfers substantially all of the benefits and risks incident to the ownership of property to the lessee, and obligates the lessee in a manner similar to that created when funds are borrowed. To enhance comparability between a firm that purchases an asset on a long-term basis and a firm that leases an asset under substantially equivalent terms, the lease should be capitalized.

b. A lessee should account for a capital lease at its inception as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding any portion of the payments representing executory costs, together with any profit thereon. However, if the present value exceeds the fair value of the leased property at the inception of the lease, the amount recorded for the asset and obligation should be the fair value.

c. A lessee should allocate each minimum lease payment between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the obligation.

d. Von should classify the first lease as a capital lease because the lease term is more than 75 percent of the estimated economic life of the machine. Von should classify the second lease as a capital lease because the lease contains a bargain purchase option.

N88
Answer 4 (10 points)

a. Skinner should report the potential costs due to the discovery of a possible product defect as an expense or loss in the income statement and as a liability in the balance sheet. In addition, Skinner should disclose the nature of the costs due to the discovery of a possible product defect.

Accrual and disclosure are required if both of the following conditions are met:

- It is considered probable that a liability has been incurred.
- The amount of loss can be reasonably estimated.

In this case both conditions are met.

b. Skinner should not report the potential claim for damages that may be received next year in the current year's income statement or balance sheet. Gain contingencies usually are not recorded in the accounts in advance of their realization. However, adequate disclosure should be made of gain contingencies, but care should be exercised to avoid misleading implications as to the likelihood of realization.

c. This year, Skinner should account for the potential costs due to the promotion campaign as a premium expense and as a liability for 70 percent of the dollar amount of the coupons issued. The amount of the liability at the end of this year would be 30 percent of the dollar amount of the coupons issued. This amount represents 70 percent of the dollar amount of the coupons issued this year less 40 percent of the dollar amount of the coupons redeemed and for which cash refunds were sent.

M88
Answer 4 (10 points)

a. The economic effect of a long-term capital lease on the lessee is similar to that of an installment purchase. Such a lease transfers substantially all of the benefits and risks incident to the ownership of property to the lessee. Therefore, the lease should be capitalized.

b. 1. Metcalf should account for the sale portion of the sale-leaseback transaction at January 1, 1987, by recording cash for the sale price, decreasing equipment at the undepreciated cost (net carrying amount) of the equipment, and establishing a deferred gain on sale-leaseback for the excess of the sale price of the equipment over its undepreciated cost (net carrying amount).

2. Metcalf should account for the leaseback portion of the sale-leaseback transaction at January 1, 1987, by recording both an asset and a liability at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding any portion of the payments representing executory costs, together with any profit. However, if the present value exceeds the fair value of the leased equipment at January 1, 1987, the amount recorded for the asset and liability should be the equipment's fair value.

c. The deferred gain should be amortized over the lease term or life of asset, whichever is appropriate. During the first year of the lease, the amortization will be an amount proportionate to the amortization of the asset. This deferral and amortization method for a sale-leaseback transaction is required because the sale and the leaseback are two components of a single transaction rather than two independent transactions. Because of this interdependence of the sale and leaseback portions of the transaction, the gain should be deferred and amortized over the lease term.

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

M91
Answer 5 (10 points)

a. The objectives of translating a foreign subsidiary's financial statements are to:

- Provide information that is generally compatible with the expected economic effects of a rate change on a subsidiary's cash flows and equity.
- Reflect the subsidiary's financial results and relationships in single currency consolidated financial statements, as measured in its functional currency and in conformity with GAAP.

b. Applying different exchange rates to the various financial statement accounts causes the restated statements to be unbalanced. The amount required to bring the restated statements into balance is termed the gain or loss from the translation or remeasurement. The gain or loss arising from remeasuring Jay A's financial statements is reported in the consolidated income statement. The gain or loss arising from translating Jay F's financial statements is reported separately under stockholders' equity in the balance sheet.

c. The functional currency is the foreign currency or parent's currency that most closely correlates with the following economic indicators:

- Cash flow indicators
- Sales price indicators
- Sales market indicators
- Expense indicators
- Financing indicators
- Intercompany transactions and arrangement indicators

d. All accounts relating to Jay A's equipment are remeasured by the exchange rate prevailing between the US and Australian dollars at the time equipment was purchased.

All accounts relating to Jay F's equipment are translated by the current exchange rates prevailing between the US dollar and French franc. For the equipment cost and accumulated depreciation this is the current exchange rate at December 31, 1990. Depreciation expense is translated at the rate prevailing on the date the depreciation expense was recognized or an appropriate weighted average exchange rate for 1990.

N90
Answer 3 (10 points)

a. The two alternative accounting methods to account for long-term construction contracts are the percentage-of completion method and the completed-contract method. The percentage-of-completion method must be used if both of the following conditions are met at the statement date:

- Reasonable estimates of profitability at completion.
- Reliable measures of progress toward completion.

If one or both of these conditions are not met at the statement date, the completed-contract method must be used.

b. The Ski Park contract must be accounted for by the percentage-of-completion method. Eighty percent of the estimated total income on the contract should be recognized as of December 31, 1989. Therefore, the 1989 income to be recognized will equal 80% of the estimated total income less the income reported under the contract in 1988.

The Nassu Village contract must be accounted for by the completed-contract method. Therefore no income or loss is recognized in 1989 under this contract.

c. The receivable on the Ski Park contract should be reported as a current asset. If costs plus gross profit to date exceed billings, the difference should be reported as a current asset. If billings exceed cost plus gross profit to date, the difference should be reported as a current liability.

N90
Answer 4 (10 points)

a. The costs of research equipment used exclusively for Trouver would be reported as research and development expenses in the period incurred.

The costs of research equipment used on both Trouver and future research projects would be capitalized and shown as equipment (less accumulated depreciation) on the balance sheet. An appropriate method of depreciation should be used. Depreciation on capitalized research equipment should be reported as a research and development expense.

b. 1. Matching refers to the process of expense recognition by associating costs with revenues on a cause and effect basis.

2. Research and development costs are usually expensed in the period incurred and may not be

matched with revenues. This accounting treatment is justified by the high degree of uncertainty regarding the amount and timing of future benefits. A direct relationship between research and development costs and future revenues generally cannot be demonstrated.

c. Corporate headquarters' costs allocated to research and development would be classified as general and administrative expenses in the period incurred, because they are not clearly related to research and development activities.

d. On Clonal's statement of cash flows, the legal expenses incurred in defending the patent should be reported under investing activities in the period paid.

M90
Answer 5 (10 points)

a. Boulder's change in depreciation method is a change in accounting principle. This change in accounting principle should show the cumulative effect of a change in accounting principle in net income of the period of change, and the pro forma effects of retroactive application for all prior periods presented currently. Financial statements of prior periods should not be restated.

Boulder's change in salvage values is a change in accounting estimate. Boulder would not report a cumulative effect, nor pro forma effects, nor would prior period financial statements be restated.

Boulder's change in the specific subsidiaries constituting the group of companies for which consolidated financial statements are presented is a change in reporting entity. Neither the cumulative effect nor the pro forma effects of the change should be reported. However, financial statements of prior periods presented currently should be restated.

b. 1. Consistent use of accounting principles from one accounting period to another enhances the comparability of accounting information across accounting periods, and thus increases the usefulness of financial statements.

2. If a change in accounting principle occurs, the nature and effect of a change in accounting principle should be disclosed to avoid misleading financial statement users. Disclosure is required because there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type.

N89
Answer 4 (10 points)

a. The interest cost component of the net pension cost for a period is the increase in the projected benefit obligation due to the passage of time. Essex would determine its interest cost component by applying an assumed discount rate to the beginning projected benefit obligation.

b. Prior service cost is the cost of retroactive benefits (increased benefits based on services rendered in prior periods) granted at the date of adoption or amendment of a pension plan. Prior service cost should be included in net pension cost during the future service periods of those employees active at the date of the pension plan adoption or amendment, as appropriate, who are expected to receive benefits under the pension plan. Prior service cost is incurred with the expectation that the employer will realize economic benefits in future periods.

c. Essex must accrue compensation for future vacations if all of the following conditions are met:

- Essex's obligation relating to employees' rights to receive compensation for future vacations is attributable to employees' services already rendered.
- The obligation relates to rights that vest or accumulate.
- Payment of the vacation benefits is probable.
- The amount can be reasonably estimated.

The theoretical rationale is that accruing compensation matches the cost of vacation benefits to the period in which services are rendered, and results in recognition of a measurable liability.

N89
Answer 5 (10 points)

a. Hillside should report the extraordinary item separately, net of applicable income taxes, below the continuing operations section in the income statement. Exclusion of extraordinary items from the results of continuing operations is intended to produce a measure of income from continuing operations that is useful in projecting future operating cash flows.

b. Hillside should report the discontinued operations separately in the 1988 income statement immediately below income from continuing operations. Discontinued operations should be comprised of two categories, with each category reported net of income taxes:

- Loss from operations of the discontinued segment from the beginning of the year to the measurement date.
- Loss on disposal of the discontinued segment, including the provision for operating losses during the phase-out period.

c. Hillside should include the costs incurred to relocate employees in the loss on disposal of the discontinued segment in its 1988 income statement. These costs are a direct result of the commitment to dispose of its segment.

M88
Answer 3 (10 points)

a. A change from the sum-of-the-years'-digits method of depreciation to the straight-line method for previously recorded assets is a change in accounting principle. Both the sum-of-the-years'-digits method and the straight-line method are generally accepted. A change in accounting principle results from adoption of a generally accepted accounting principle different from the generally accepted accounting principle used previously for reporting purposes.

b. A change in the expected service life of an asset arising because of more experience with the asset is a change in accounting estimate. A change in accounting estimate occurs because future events and their effects cannot be perceived with certainty. Estimates are an inherent part of the accounting process. Therefore, accounting and reporting for certain financial statement elements requires the exercise of judgment, subject to revision based on experience.

c. 1. The cumulative effect of a change in accounting principle is the difference between (1) the amount of retained earnings at the beginning of the period of change and (2) the amount of retained earnings that would have been reported at that date if the new accounting principle had been used in prior periods.

2. The cumulative effect, net of income taxes, should be shown as a separate item in the income statement for the period of change between the captions "extraordinary items" and "net income". Pro-forma disclosure of the effects of retroactive restatement should be shown on the face of the income statement.

d. 1. Consistent use of accounting principles from one accounting period to another enhances the utility of financial statements to users of comparative accounting data.

2. If a change in accounting principle occurs, the nature and effect of a change in accounting principle should be disclosed to avoid misleading financial statement users. There is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type.

M88
Answer 5 (10 points)

a. The two accounting problems resulting from the nature of the defined benefit pension plan are as follows:

- Estimates or assumptions must be made concerning the future events that will determine the amount and timing of the benefit payments.
- Some approach to attributing the cost of pension benefits to individual years of service must be selected.

The two problems arise because a company must recognize pension costs before it pays pension benefits.

b. Carson should determine the service cost component of the net pension cost as the actuarial present value of pension benefits attributable to employee services during a particular period based on the application of the pension benefit formula.

c. Carson should determine the interest cost component of the net pension cost as the increase in the projected benefit obligation due to the passage of time. Measuring the projected benefit obligation requires accrual of an interest cost at an assumed discount rate.

d. Carson should determine the actual return on plan assets component of the net pension cost as the change in the fair value of plan assets during the period, adjusted for (1) contributions and (2) benefit payments.

VI. Other Financial Topics

M92
Answer 5 (10 points)

a. The components of Bighorn's 1991 net pension cost calculation are:

- Service cost.
- Interest cost.
- Actual return on plan assets.
- Gain or loss consisting of:
  - The difference between the actual and expected return on plan assets.
  - Any amortization of the unrecognized gain or loss from previous periods.

b. 1. Bighorn's unrecognized net loss results from differences between actuarial assumptions and experiences for both its projected benefit obligation and returns on plan assets.

2. Bighorn's unfunded accrued pension cost occurs because cumulative net pension expense exceeds cash contributed to the pension fund.

c. Bighorn's minimum pension liability equals the excess of the accumulated benefit obligation over the fair value of plan assets. Bighorn's additional pension liability would equal any excess of this minimum pension liability over the unfunded accrued pension cost.

N91
Answer 5 (10 points)

a. Segment disclosures assist in analyzing and understanding financial statements by permitting better assessment of past performance and future prospects. Disaggregated information provides more precise details of the uncertainties surrounding the timing and the amount of expected cash flows, because the various segments may have different rates of profitability, degrees and types of risk, opportunities for growth, and future capital demands.

b. Barnet should have reported an industry segment that satisfies one or more of the following tests:

1. The segment's revenue, including both sales to unaffiliated customers and intersegment sales or transfers, is 10% or more of the combined revenue of all Barnet's industry segments.
2. The segment's absolute amount of operating profit or loss is 10% or more of the greater in absolute amount of:
   - The combined operating profit of all industry segments with operating profits, or
   - The combined operating loss of all industry segments with operating losses.
3. The segment's identifiable assets are 10% or more of the combined identifiable assets of all industry segments.

c. Barnet's 1991 income statement should report the results of discontinued boating operations separately and immediately below income from continuing operations. Discontinued boating operations should be composed of the following two categories, with each category shown net of income taxes:

- Profit from operations for the period January 1 to July 31, 1991.
- Loss on disposal equal to the expected loss on the boating asset sale, less the profits earned and expected to be earned for the period August 1, 1991, through February 28, 1992.

M91
Answer 2 (10 points)

a. A business combination accounted for as a pooling-of-interests is a continuation of ownership interests of previously separate companies. Each stockholder group retains risk and benefit elements from its former investments to which are added risks and benefits obtained through mutual exchanges with the other group or groups. Total resources of the pooled entity remain intact.

b. At least 90% of Sib's outstanding common stock must be exchanged on December 31, 1990, for the combination to be treated as a pooling-of-interests.

c. 1. The December 31, 1990, consolidated balance sheet reports assets and liabilities at the sum of Pap's and Sib's carrying amounts before the combination.

2. Johnson's proportional ownership in Sib is reported as a minority interest regardless of the type of combination accounting. In pooling-of-interests accounting, to report the controlling stockholders' equity, the balance of Sib's stockholders' equity is added to Pap's stockholders' equity before the combination, with components as follows:

- Common stock equals the par value of Pap's common stock outstanding after the combination.
- Additional paid-in capital equals the sum of the two companies' additional paid-in capital before the combination less:
  - Johnson's proportional interest in Sib's additional paid-in capital, and
  - Excess of the par value of new Pap stock issued over par value of Sib stock exchanged.

  If a negative amount arises from this calculation it is deducted from combined retained earnings.
- Retained earnings equals the sum of the separate retained earnings before the combination less
  - Johnson's proportional interest in Sib's retained earnings, and
  - Any deduction, as noted above, required for the issue of Pap's common stock.

N90
Answer 5 (10 points)

a. Gunpowder's stock option measurement date is January 2, 1987. The stock option measurement date is the first date on which the employer knows both:

- The number of shares that an individual is entitled to receive, and
- The option or purchase price.

b. The compensation expense for 1987 is equal to the market price of Gunpowder's stock on January 2, 1987, less the option price, times the number of options outstanding times one-half.

c. When options are forfeited, compensation expense, contributed capital-stock options, and deferred compensation (if used) are all decreased. This is necessary because the total compensation expense is less than that estimated in 1987.

d. Cash was increased by the stock option price [90% of the quoted market price on January 2, 1987] multiplied by the number of shares issued. Retained earnings was reduced by the compensation expense recorded in 1987 and 1988. Contributed capital was increased by the balancing amount for the above entries.

N88
Answer 5 (10 points)

a. 1. A business combination accounted for as a purchase is an arms-length transaction in which one company acquires another company. The purchased company is treated as an acquired asset and is recorded at its cost to the acquiring company. Therefore, a new basis of accounting is established for the net assets of the acquired company.

2. All identifiable assets acquired and liabilities assumed in a business combination should be recorded at their fair values at date of acquisition. If the cost of the acquired company exceeds the fair value of the identifiable net assets acquired, the excess should be recorded as goodwill.

3. Goodwill should be amortized by charges to income over the periods estimated to be benefited. The period of amortization should not, however, exceed 40 years. The straight-line method of amortization should be applied unless a company demonstrates that another systematic method is more appropriate.

b. 1. A business combination accounted for as a pooling of interests is a combination of ownership interests of previously separate companies. As a result, the existing basis of accounting continues for both companies.

2. In a pooling of interests, the carrying amount of stockholders' equities of the separate companies are combined. Normally, the combined corporation records as contributed capital the capital stock and capital in excess of par or stated value of outstanding stock of the separate companies. Similarly, retained earnings or deficits of the separate companies are combined and recognized as retained earnings of the combined corporation.

The amount of outstanding shares of stock of the combined corporation at par or stated value may exceed the total amount of capital stock of the combining companies. The excess should be deducted first from the combined other contributed capital and then from the combined retained earnings.

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Auditing

Selected Questions And Unofficial Answers Indexed To Content Specification Outline

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* No other objective answers formats or essays were indexed for this group.
† Questions in this area are not classified according to group.

MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. Professional Responsibilities

A. General Standards and Code of Professional Conduct

M92#56. Must a CPA in public practice be independent in fact and appearance when providing the following services?

	Compilation of personal financial statements	*Preparation of a tax return*	*Compilation of a financial forecast*
a.	No	No	No
b.	No	No	Yes
c.	Yes	No	No
d.	No	Yes	No

N91#2. A violation of the profession's ethical standards **least** likely would have occurred when a CPA

a. Purchased another CPA's accounting practice and based the price on a percentage of the fees accruing from clients over a three-year period.
b. Received a percentage of the amounts invested by the CPA's audit clients in a tax shelter with the clients' knowledge and approval.
c. Had a public accounting practice and also was president and sole stockholder of a corporation that engaged in data processing services for the public.
d. Formed an association — **not** a partnership — with two other sole practitioners and called the association "Adams, Betts and Associates."

N91#9. Which of the following best describes what is meant by the term generally accepted auditing standards?

a. Procedures to be used to gather evidence to support financial statements.
b. Measures of the quality of the auditor's performance.
c. Pronouncements issued by the Auditing Standards Board.
d. Rules acknowledged by the accounting profession because of their universal application.

M91#52. The concept of materiality would be **least** important to an auditor when considering the

a. Adequacy of disclosure of a client's illegal act.
b. Discovery of weaknesses in a client's internal control structure.
c. Effects of a direct financial interest in the client on the CPA's independence.
d. Decision whether to use positive or negative confirmations of accounts receivable.

M91#57. A violation of the profession's ethical standards most likely would have occurred when a CPA

a. Compiled the financial statements of a client that employed the CPA's spouse as a bookkeeper.
b. Received a fee for referring audit clients to a company that sells limited partnership interests.
c. Purchased the portion of an insurance company that performs actuarial services for employee benefit plans.
d. Arranged with a financial institution to collect notes issued by a client in payment of fees due.

N90#37. An accountant who is **not** independent of a client is precluded from issuing a

a. Report on management advisory services.
b. Compilation report on historical financial statements.
c. Compilation report on prospective financial statements.
d. Special report on compliance with contractual agreements.

N90#39. Which of the following standards requires a critical review of the work done and the judgment exercised by those assisting in an audit at every level of supervision?

a. Proficiency.
b. Audit risk.
c. Inspection.
d. Due care.

M90#46. The first general standard requires that an audit of financial statements is to be performed by a person or persons having

a. Seasoned judgment in varying degrees of supervision and review.
b. Adequate technical training and proficiency.
c. Knowledge of the standards of field work and reporting.
d. Independence with respect to the financial statements and supplementary disclosures.

M90#47. The exercise of due professional care requires that an auditor

a. Examine all available corroborating evidence.
b. Critically review the judgment exercised at every level of supervision.
c. Reduce control risk below the maximum.
d. Attain the proper balance of professional experience and formal education.

N89#49. The third general standard states that due care is to be exercised in the performance of an audit. This standard is generally interpreted to require

a. Objective review of the adequacy of the technical training and proficiency of firm personnel.
b. Critical review of work done at every level of supervision.
c. Thorough review of the existing internal control structure.
d. Periodic review of a CPA firm's quality control procedures.

N89#56. The profession's ethical standards would most likely be considered to have been violated when a CPA

a. Continued an audit engagement after the commencement of litigation against the CPA alleging excessive fees filed in a stockholders' derivative action.
b. Represented to a potential client that the CPA's fees were substantially lower than the fees charged by other CPAs for comparable services.
c. Issued a report on a financial forecast that omitted a caution regarding achievability.
d. Accepted an MAS consultation engagement concerning data processing services for which the CPA lacked independence.

N89#57. If requested to perform a review engagement for a nonpublic entity in which an accountant has an immaterial direct financial interest, the accountant is

a. Independent because the financial interest is immaterial and, therefore, may issue a review report.
b. Not independent and, therefore, may **not** be associated with the financial statements.
c. Not independent and, therefore, may **not** issue a review report.
d. Not independent and, therefore, may issue a review report, but may **not** issue an auditor's opinion.

M89#2. Which of the following bodies promulgates standards for audits of federal financial assistance recipients?

a. Governmental Accounting Standards Board.
b. Financial Accounting Standards Board.
c. General Accounting Office.
d. Governmental Auditing Standards Board.

M89#3. According to the profession's ethical standards, an auditor would be considered independent in which of the following instances?

a. The auditor's checking account, which is fully insured by a federal agency, is held at a client financial institution.
b. The auditor is also an attorney who advises the client as its general counsel.
c. An employee of the auditor donates service as treasurer of a charitable organization that is a client.
d. The client owes the auditor fees for two consecutive annual audits.

N88#2. Which of the following elements underlies the application of generally accepted auditing standards, particularly the standards of field work and reporting?

a. Internal accounting control.
b. Corroborating evidence.
c. Quality control.
d. Materiality and relative risk.

N88#3. Which of the following acts by a CPA who is **not** in public practice would most likely be considered a violation of the ethical standards of the profession?

a. Using the CPA designation without disclosing employment status in connection with financial statements issued for external use by the CPA's employer.
b. Distributing business cards indicating the CPA designation and the CPA's title and employer.
c. Corresponding on the CPA's employer's letterhead, which contains the CPA designation and the CPA's employment status.
d. Compiling the CPA's employer's financial statements and making reference to the CPA's lack of independence.

N88#4. The ethical standards of the profession would most likely be considered to be violated if a CPA

a. Owns a building and leases a portion of the space to an audit client.
b. Has an insured account with a brokerage firm that is an audit client and the account is used for occasional cash transactions.
c. Is asked by an audit client to act as a "finder" in the acquisition of another company on a per diem basis.
d. Searches for and initially screens candidates for the vacant controllership of an audit client.

N88#5. Which of the following statements best explains why the CPA profession has found it essential to promulgate ethical standards and to establish means for ensuring their observance?

a. Vigorous enforcement of an established code of ethics is the best way to prevent unscrupulous acts.

b. Ethical standards that emphasize excellence in performance over material rewards establish a reputation for competence and character.
c. A distinguishing mark of a profession is its acceptance of responsibility to the public.
d. A requirement for a profession is to establish ethical standards that stress primarily a responsibility to clients and colleagues.

M88#51. The exercise of due professional care requires that an auditor
a. Use error-free judgment.
b. Study and review internal accounting control, including compliance tests.
c. Critically review the work done at every level of supervision.
d. Examine all corroborating evidence available.

M88#52. Under which of the following circumstances would the independence of a CPA be considered impaired if the CPA, who is also an attorney, serves as auditor and provides legal services to the same client?
a. When the CPA, as legal agent, consummates a business acquisition for the client.
b. When the CPA's audit fees and legal fees are **not** billed separately.
c. When the CPA uses legal expertise to research a question of income tax law.
d. When the legal services consist of an analysis of the terms of a lease agreement.

M88#53. A violation of the profession's ethical standards would most likely have occurred when a CPA
a. Purchased a bookkeeping firm's practice of monthly write-ups for a percentage of fees received over a three-year period.
b. Made arrangements with a bank to collect notes issued by a client in payment of fees due.
c. Named Smith formed a partnership with two other CPAs and use "Smith & Co." as the firm name.
d. Issued an unqualified opinion on the 1987 financial statements when fees for the 1986 audit were unpaid.

B. Control of the Audit

M92#57. Inherent risk and control risk differ from detection risk in that inherent risk and control risk are
a. Elements of audit risk while detection risk is **not**.
b. Changed at the auditor's discretion while detection risk is **not**.
c. Considered at the individual account-balance level while detection risk is **not**.
d. Functions of the client and its environment while detection risk is **not**.

M92#58. Analytical procedures used in planning an audit should focus on
a. Identifying possible scope limitations and gathering evidence in assessing control risk environmental factors.
b. Enhancing the understanding of the entity's business and the transactions and events that have occurred since the last audit.
c. Aggregating data at a low level and substantiating management's assertions that are embodied in the financial statements.
d. Discovering material weaknesses in the internal control structure and reporting them to the entity's management for corrective action.

N91#1. A CPA firm would be reasonably assured of meeting its responsibility to provide services that conform with professional standards by
a. Adhering to generally accepted auditing standards.
b. Having an appropriate system of quality control.
c. Joining professional societies that enforce ethical conduct.
d. Maintaining an attitude of independence in its engagements.

N91#3. Which of the following procedures would an auditor most likely perform in planning a financial statement audit?
a. Reviewing investment transactions of the audit period to determine whether related parties were created.
b. Performing analytical procedures to identify areas that may represent specific risks.
c. Reading the minutes of stockholder and director meetings to discover whether any unusual transactions have occurred.
d. Obtaining a written representation letter from the client to emphasize management's responsibilities.

N91#4. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding
a. Disagreements the predecessor had with the client concerning auditing procedures and accounting principles.
b. The predecessor's evaluation of matters of continuing accounting significance.
c. The degree of cooperation the predecessor received concerning the inquiry of the client's lawyer.
d. The predecessor's assessments of inherent risk and judgments about materiality.

N91#5. The audit work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the
a. Audit has been performed by persons having adequate technical training and proficiency as auditors.

b. Auditor's system of quality control has been maintained at a high level.
c. Results are consistent with the conclusions to be presented in the auditor's report.
d. Audit procedures performed are approved in the professional standards.

N91#6. The existence of audit risk is recognized by the statement in the auditor's standard report that the auditor
a. Obtains reasonable assurance about whether the financial statements are free of material misstatement.
b. Assesses the accounting principles used and also evaluates the overall financial statement presentation.
c. Realizes some matters, either individually or in the aggregate, are important while other matters are **not** important.
d. Is responsible for expressing an opinion on the financial statements, which are the responsibility of management.

N91#7. The risk that an auditor will conclude, based on substantive tests, that a material error does **not** exist in an account balance when, in fact, such error does exist is referred to as
a. Sampling risk.
b. Detection risk.
c. Nonsampling risk.
d. Inherent risk.

N91#8. In developing a preliminary audit strategy, an auditor should consider
a. Whether the allowance for sampling risk exceeds the achieved upper precision limit.
b. Findings from substantive tests performed at interim dates.
c. Whether the inquiry of the client's attorney identifies any litigation, claims, or assessments **not** disclosed in the financial statements.
d. The planned assessed level of control risk.

N90#36. A CPA firm evaluates its personnel advancement experience to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. This is evidence of the firm's adherence to which of the following prescribed standards
a. Quality control.
b. Human resources.
c. Supervision and review.
d. Professional development.

M90#3. Analytical procedures used in planning an audit should focus on identifying
a. Material weaknesses in the internal control structure.
b. The predictability of financial data from individual transactions.
c. The various assertions that are embodied in the financial statements.
d. Areas that may represent specific risks relevant to the audit.

M90#50. In planning a new engagement, which of the following is **not** a factor that affects the auditor's judgment as to the quantity, type, and content of working papers?
a. The type of report to be issued by the auditor.
b. The content of the client's representation letter.
c. The auditor's estimated occurrence rate of attributes.
d. The auditor's preliminary evaluations of risk based on discussions with the client.

M90#51. When planning a sample for a substantive test of details, an auditor should consider tolerable misstatement for the sample. This consideration should
a. Be related to the auditor's business risk.
b. Not be adjusted for qualitative factors.
c. Be related to preliminary judgments about materiality levels.
d. Not be changed during the audit process.

M90#52. The element of the audit planning process most likely to be agreed upon with the client before implementation of the audit strategy is the determination of the
a. Timing of inventory observation procedures to be performed.
b. Evidence to be gathered to provide a sufficient basis for the auditor's opinion.
c. Procedures to be undertaken to discover litigation, claims, and assessments.
d. Pending legal matters to be included in the inquiry of the client's attorney.

M90#53. The scope and nature of an auditor's contractual obligation to a client ordinarily is set forth in the
a. Management letter.
b. Scope paragraph of the auditor's report.
c. Engagement letter.
d. Introductory paragraph of the auditor's report.

M90#54. Which of the following are elements of a CPA firm's quality control that should be considered in establishing its quality control policies and procedures?

	Advancement	*Inspection*	*Consultation*
a.	Yes	Yes	No
b.	Yes	Yes	Yes
c.	No	Yes	Yes
d.	Yes	No	Yes

M89#4. A CPA firm's quality control procedures pertaining to the acceptance of a prospective audit client would most likely include
a. Inquiry of management as to whether disagreements between the predecessor auditor and the prospective client were resolved satisfactorily.
b. Consideration of whether sufficient competent evidential matter may be obtained to afford a reasonable basis for an opinion.
c. Inquiry of third parties, such as the prospective client's bankers and attorneys, about information regarding the prospective client and its management.
d. Consideration of whether the internal control structure is sufficiently effective to permit a reduction in the extent of required substantive tests.

M89#5. Which of the following audit risk components may be assessed in nonquantitative terms?

	Inherent risk	*Control risk*	*Detection risk*
a.	Yes	Yes	No
b.	Yes	No	Yes
c.	No	Yes	Yes
d.	Yes	Yes	Yes

N88#6. Which of the following procedures would an auditor most likely include in the initial planning of an examination of financial statements?
a. Discussing the examination with firm personnel responsible for non-audit services to the client.
b. Inquiring of the client's attorney as to any claims probable of assertion.
c. Obtaining a written representation letter from management of the client.
d. Determining whether necessary internal accounting control procedures are being applied as prescribed.

N88#11. A CPA firm should establish procedures for conducting and supervising work at all organizational levels to provide reasonable assurance that the work performed meets the firm's standards of quality. To achieve this goal, the firm most likely would establish procedures for
a. Evaluating prospective and continuing client relationships.
b. Reviewing engagement working papers and reports.
c. Requiring personnel to adhere to the applicable independence rules.
d. Maintaining personnel files containing documentation related to the evaluation of personnel.

N88#23. An auditor's document includes the following statement:

"Our audit is subject to the risk that errors, irregularities, or illegal acts, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of any such matters that come to our attention."

The above passage is most likely from
a. The explanatory paragraph of a "subject to" qualified auditor's report.
b. An engagement letter.
c. The explanatory paragraph of a compliance report on a governmental entity subject to GAO standards.
d. A comfort letter.

N88#33. A basic objective of a CPA firm is to provide professional services that conform with professional standards. Reasonable assurance of achieving this basic objective is provided through
a. Compliance with generally accepted reporting standards.
b. A system of quality control.
c. A system of peer review.
d. Continuing professional education.

M88#54. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding the predecessor's
a. Awareness of the consistency in the application of generally accepted accounting principles between periods.
b. Evaluation of all matters of continuing accounting significance.
c. Opinion of any subsequent events occurring since the predecessor's audit report was issued.
d. Understanding as to the reasons for the change of auditors.

M88#55. When planning an examination, an auditor should
a. Consider whether the extent of substantive tests may be reduced based on the results of the internal control questionnaire.
b. Make preliminary judgments about materiality levels for audit purposes.
c. Conclude whether changes in compliance with prescribed control procedures justifies reliance on them.
d. Prepare a preliminary draft of the management representation letter.

M88#56. A difference of opinion regarding the results of a sample can not be resolved between the assistant who performed the auditing procedures and the in-charge auditor. The assistant should
a. Refuse to perform any further work on the engagement.
b. Accept the judgment of the more experienced in-charge auditor.
c. Document the disagreement and ask to be disassociated from the resolution of the matter.
d. Notify the client that a serious audit problem exists.

C. Other Responsibilities

M92#59. What assurance does the auditor provide that errors, irregularities, and direct effect illegal acts that are material to the financial statements will be detected?

	Errors	*Irregularities*	*Direct effect illegal acts*
a.	Limited	Negative	Limited
b.	Limited	Limited	Reasonable
c.	Reasonable	Limited	Limited
d.	Reasonable	Reasonable	Reasonable

M92#60. An attestation engagement is one in which a CPA is engaged to
- a. Issue a written communication expressing a conclusion about the reliability of a written assertion that is the responsibility of another party.
- b. Provide tax advice or prepare a tax return based on financial information the CPA has **not** audited or reviewed.
- c. Testify as an expert witness in accounting, auditing, or tax matters, given certain stipulated facts.
- d. Assemble prospective financial statements based on the assumptions of the entity's management without expressing any assurance.

N91#10. Which of the following statements describes why a properly designed and executed audit may **not** detect a material irregularity?
- a. Audit procedures that are effective for detecting an unintentional misstatement may be ineffective for an intentional misstatement that is concealed through collusion.
- b. An audit is designed to provide reasonable assurance of detecting material errors, but there is **no** similar responsibility concerning material irregularities.
- c. The factors considered in assessing control risk indicated an increased risk of intentional misstatements, but only a low risk of unintentional errors in the financial statements.
- d. The auditor did **not** consider factors influencing audit risk for account balances that have effects pervasive to the financial statements taken as a whole.

N91#11. When an auditor becomes aware of a possible client illegal act, the auditor should obtain an understanding of the nature of the act to
- a. Increase the assessed level of control risk.
- b. Recommend remedial actions to the audit committee.
- c. Evaluate the effect on the financial statements.
- d. Determine the reliability of management's representations.

N91#12. Which of the following circumstances most likely would cause an auditor to consider whether material misstatements exist in an entity's financial statements?
- a. Supporting records that should be readily available are frequently **not** produced when requested.
- b. Reportable conditions previously communicated have **not** been corrected.
- c. Clerical errors are listed on a monthly computer-generated exception report.
- d. Differences are discovered during the client's annual physical inventory count.

N91#13. Statements on Standards for Accounting and Review Services establish standards and procedures for which of the following engagements?
- a. Assisting in adjusting the books of account for a partnership.
- b. Reviewing interim financial data required to be filed with the SEC.
- c. Processing financial data for clients of other accounting firms.
- d. Compiling an individual's personal financial statement to be used to obtain a mortgage.

N91#14. Which of the following general standards apply to MAS engagements and consultations?

	Due professional care	*Independence in mental attitude*	*Planning and supervision*
a.	No	Yes	No
b.	No	Yes	Yes
c.	Yes	No	Yes
d.	Yes	No	No

N91#15. Which of the following statements is correct concerning a CPA's responsibility when the CPA uses taxpayer estimates in preparing a tax return?
- a. Tax preparation requires the CPA to exercise judgment, but prohibits the CPA's use of estimates and approximations.
- b. Use of taxpayer estimates in a tax return is prohibited unless they are specifically disclosed by the CPA.
- c. When all facts relating to a transaction are **not** accurately known because records are missing, reasonable estimates made by the taxpayer of the missing data may be used by the CPA.
- d. The CPA may prepare tax returns involving the use of taxpayer estimates even if it is practical to obtain exact data.

M91#51. Which of the following professional services would be considered an attest engagement?
- a. A management consulting engagement to provide EDP advice to a client.
- b. An engagement to report on compliance with statutory requirements.

c. An income tax engagement to prepare federal and state tax returns.
d. The compilation of financial statements from a client's accounting records.

M91#56. When a CPA prepares a client's federal income tax return, the CPA has the responsibility to
a. Take a position of independent neutrality.
b. Argue the position of the Internal Revenue Service.
c. Be an advocate for the entity's realistically sustainable position.
d. Verify the data to be used in preparing the return.

M91#58. Blue Co., a privately held entity, asked its tax accountant, Cook, a CPA in public practice, to reproduce Blue's internally prepared interim financial statements on Cook's microcomputer when Cook prepared Blue's quarterly tax return. Cook should **not** submit these financial statements to Blue unless, as a minimum, Cook complies with the provisions of
a. Statements on Responsibilities in Tax Practice.
b. Statements on Standards for Accounting and Review Services.
c. Statements on Responsibilities in Unaudited Financial Services.
d. Statements on Standards for Attestation Engagements.

N90#38. Which of the following circumstances is most likely to cause an auditor to consider whether a material misstatement exists?
a. Transactions selected for testing are **not** supported by proper documentation.
b. The turnover of senior accounting personnel is exceptionally low.
c. Management places little emphasis on meeting earnings projections.
d. Operating and financing decisions are dominated by several persons.

M90#48. On completing an audit, Larkin, CPA, was asked by the client to provide technical assistance in the implementation of a new EDP system. The set of pronouncements designed to guide Larkin in this engagement is the Statements on
a. Auditing Standards.
b. Standards for Management Advisory Services.
c. Quality Control Standards.
d. Standards for Accountants' EDP Services.

M90#49. Which of the following is the authoritative body designated to promulgate attestation standards?
a. Auditing Standards Board.
b. Governmental Accounting Standards Board.
c. Financial Accounting Standards Board.
d. General Accounting Office.

M90#55. Disclosure of irregularities to parties other than a client's senior management and its audit committee or board of directors ordinarily is not part of an auditor's responsibility. However, to which of the following outside parties may a duty to disclose irregularities exist?

	To the SEC when the client reports an auditor change	*To a successor auditor when the successor makes appropriate inquiries*	*To a government funding agency from which the client receives financial assistance*
a.	Yes	Yes	No
b.	Yes	No	Yes
c.	No	Yes	Yes
d.	Yes	Yes	Yes

M90#56. Which of the following statements best describes an auditor's responsibility to detect errors and irregularities?
a. The auditor should study and evaluate the client's internal control structure, and design the audit to provide reasonable assurance of detecting all errors and irregularities.
b. The auditor should assess the risk that errors and irregularities may cause the financial statements to contain material misstatements, and determine whether the necessary internal control procedures are prescribed and are being followed satisfactorily.
c. The auditor should consider the types of errors and irregularities that could occur, and determine whether the necessary internal control procedures are prescribed and are being followed.
d. The auditor should assess the risk that errors and irregularities may cause the financial statements to contain material misstatements, and design the audit to provide reasonable assurance of detecting material errors and irregularities.

M90#57. Morris, CPA, suspects that a pervasive scheme of illegal bribes exists throughout the operations of Worldwide Import–Export, Inc., a new audit client. Morris notified the audit committee and Worldwide's legal counsel, but neither could assist Morris in determining whether the amounts involved were material to the financial statements or whether senior management was involved in the scheme. Under these circumstances, Morris should
a. Express an unqualified opinion with a separate explanatory paragraph.
b. Disclaim an opinion on the financial statements.
c. Express an adverse opinion on the financial statements.
d. Issue a special report regarding the illegal bribes.

M90#58. Which of the following statements concerning illegal acts by clients is correct?

a. An auditor's responsibility to detect illegal acts that have a direct and material effect on the financial statements is the same as that for errors and irregularities.
b. An audit in accordance with generally accepted auditing standards normally includes audit procedures specifically designed to detect illegal acts that have an indirect but material effect on the financial statements.
c. An auditor considers illegal acts from the perspective of the reliability of management's representations rather than their relation to audit objectives derived from financial statement assertions.
d. An auditor has **no** responsibility to detect illegal acts by clients that have an indirect effect on the financial statements.

M90#59. If compiled financial statements presented in conformity with the cash receipts and disbursements basis of accounting do **not** disclose the basis of accounting used, the accountant should

a. Recompile the financial statements using generally accepted accounting principles.
b. Disclose the basis in the notes to the financial statements.
c. Clearly label each page "Unaudited."
d. Disclose the basis of accounting in the accountant's report.

N89#59. Which of the following factors is most important concerning an auditor's responsibility to detect errors and irregularities?

a. The susceptibility of the accounting records to intentional manipulations, alterations, and the misapplication of accounting principles.
b. The probability that unreasonable accounting estimates result from unintentional bias or intentional attempts to misstate the financial statements.
c. The possibility that management fraud, defalcations, and the misappropriation of assets may indicate the existence of illegal acts.
d. The risk that mistakes, falsifications, and omissions may cause the financial statements to contain material misstatements.

N89#60. If specific information comes to an auditor's attention that implies the existence of possible illegal acts that could have a material, but indirect effect on the financial statements, the auditor should next

a. Apply audit procedures specifically directed to ascertaining whether an illegal act has occured.
b. Seek the advice of an informed expert qualified to practice law as to possible contingent liabilities.
c. Report the matter to an appropriate level of management at least one level above those involved.
d. Discuss the evidence with the client's audit committee, or others with equivalent authority and responsibility.

N88#9. Which of the following circumstances would most likely cause an auditor to suspect that material irregularities exist in a client's financial statements?

a. Property and equipment are usually sold at a loss before being fully depreciated.
b. Significantly fewer responses to confirmation requests are received than expected.
c. Monthly bank reconciliations usually include several in-transit items.
d. Clerical errors are listed on an EDP-generated exception report.

N88#10. An auditor's tests of the pricing of a client's inventory indicates the existence of many errors. However, because of inadequate records the auditor is uncertain about whether these errors materially affect the financial statements taken as a whole. The auditor may reasonably issue a (an)

	"Subject to" qualified opinion	*Adverse opinion*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N88#12. An auditor of a manufacturer would most likely question whether that client has committed illegal acts if the client has

a. Been forced to discontinue operations in a foreign country.
b. Been an annual donor to a local political candidate.
c. Failed to correct material weaknesses in internal accounting control that were reported after the prior year's audit.
d. Disclosed several subsequent events involving foreign operations in the notes to the financial statements.

N88#15. Which of the following standards applies to management advisory services engagements?

a. In all matters relating to the assignment, an independence in mental attitude is to be maintained.
b. There is to be a proper study and evaluation of the existing internal accounting control as a basis for reliance thereon.
c. The work is to be adequately planned and assistants are to be properly supervised.
d. Informative disclosures are to be regarded as reasonably adequate unless otherwise stated in the report.

N88#30. An accountant should **not** submit unaudited financial statements to the management of a nonpublic company unless, at a minimum, the accountant

a. Assists in adjusting the books of account and prepares the trial balance.
b. Types or reproduces the financial statements on plain paper.
c. Complies with the standards applicable to compilation engagements.
d. Applies analytical procedures to the financial statements.

M88#58. An entity's financial statements were misstated over a period of years due to large amounts of revenue being recorded in journal entries that involved debits and credits to an illogical combination of accounts. The auditor could most likely have been alerted to this irregularity by

a. Scanning the general journal for unusual entries.
b. Performing a revenue cut-off test at year-end.
c. Tracing a sample of journal entries to the general ledger.
d. Examining documentary evidence of sales returns and allowances recorded after year-end.

M88#59. The refusal of a client's attorney to provide a representation on the legality of a particular act committed by the client is generally

a. Sufficient reason to issue a "subject to" qualified opinion.
b. Considered to be a scope limitation.
c. Insufficient reason to modify the auditor's report due to the attorney's obligation of confidentiality.
d. Proper grounds to withdraw from the engagement.

II. Internal Control

A. Definitions and Basic Concepts

M92#36. An auditor anticipates assessing control risk at a low level in a computerized environment. Under these circumstances, on which of the following procedures would the auditor initially focus?

a. Programmed control procedures.
b. Application control procedures.
c. Output control procedures.
d. General control procedures.

M92#37. When an auditor increases the planned assessed level of control risk because certain control procedures were determined to be ineffective, the auditor would most likely increase the

a. Extent of tests of details.
b. Level of inherent risk.
c. Extent of tests of controls.
d. Level of detection risk.

M92#38. For certain controls, such as segregation of duties, documentary evidence may not exist. An auditor would most likely test the procedures by

a. Reperformance and corroboration.
b. Observation and inquiry.
c. Inspection and vouching.
d. Confirmation and recomputation.

N91#32. Which of the following is a general control that would most likely assist an entity whose systems analyst left the entity in the middle of a major project?

a. Grandfather-father-son record retention.
b. Input and output validation routines.
c. Systems documentation.
d. Check digit verification.

N91#33. Which of the following statements most likely represents a disadvantage for an entity that keeps microcomputer-prepared data files rather than manually prepared files?

a. Random error associated with processing similar transactions in different ways is usually greater.
b. It is usually more difficult to compare recorded accountability with physical count of assets.
c. Attention is focused on the accuracy of the programming process rather than errors in individual transactions.
d. It is usually easier for unauthorized persons to access and alter the files.

M91#21. Evidential matter concerning proper segregation of duties ordinarily is best obtained by

a. Preparation of a flowchart of duties performed by available personnel.
b. Inquiring whether control procedures operated consistently throughout the period.
c. Reviewing job descriptions prepared by the personnel department.
d. Direct personal observation of the employees who apply control procedures.

M91#22. An auditor assesses control risk because it

a. Indicates where inherent risk may be the greatest.
b. Affects the level of detection risk the auditor may accept.
c. Determines whether sampling risk is sufficiently low.
d. Includes the aspects of nonsampling risk that are controllable.

M91#23. When considering the objectivity of internal auditors, an independent auditor should

a. Test a sample of the transactions and balances that the internal auditors examined.
b. Determine the organizational level to which the internal auditors report.
c. Evaluate the quality control program in effect for the internal auditors.
d. Examine documentary evidence of the work performed by the internal auditors.

N90#41. The objective of tests of details of transactions performed as tests of controls is to

a. Detect material misstatements in the account balances of the financial statements.
b. Evaluate whether an internal control structure policy or procedure operated effectively.
c. Determine the nature, timing, and extent of substantive tests for financial statement assertions.
d. Reduce control risk, inherent risk, and detection risk to an acceptably low level.

N90#42. An auditor uses the knowledge provided by the understanding of the internal control structure and the final assessed level of control risk primarily to determine the nature, timing, and extent of the

a. Attribute tests.
b. Compliance tests.
c. Tests of controls.
d. Substantive tests.

M90#27. Which of the following computer documentation would an auditor most likely utilize in obtaining an understanding of the internal control structure?

a. Systems flowcharts.
b. Record counts.
c. Program listings.
d. Record layouts.

M90#28. Miller Retailing, Inc. maintains a staff of three fulltime internal auditors who report directly to the controller. In planning to use the internal auditors to provide assistance in performing the audit, the independent auditor most likely will

a. Place limited reliance on the work performed by the internal auditors.
b. Decrease the extent of the tests of controls needed to support the assessed level of detection risk.
c. Increase the extent of the procedures needed to reduce control risk to an acceptable level.
d. Avoid using the work performed by the internal auditors.

N89#36. An auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk primarily to

a. Determine whether procedures and records concerning the safeguarding of assets are reliable.
b. Ascertain whether the opportunities to allow any person to both perpetrate and conceal irregularities are minimized.
c. Modify the initial assessments of inherent risk and preliminary judgments about materiality levels.
d. Determine the nature, timing, and extent of substantive tests for financial statement assertions.

N89#37. An auditor's flowchart of a client's accounting system is a diagrammatic representation that depicts the auditor's

a. Program for tests of controls.
b. Understanding of the system.
c. Understanding of the types of irregularities that are probable, given the present system.
d. Documentation of the study and evaluation of the system.

N89#38. Computer systems are typically supported by a variety of utility software packages that are important to an auditor because they

a. May enable unauthorized changes to data files if **not** properly controlled.
b. Are very versatile programs that can be used on hardware of many manufacturers.
c. May be significant components of a client's application programs.
d. Are written specifically to enable auditors to extract and sort data.

M89#6. The development of constructive suggestions to a client for improvements in its internal control structure is

a. Addressed by the auditor only during a special engagement.
b. As important as establishing a basis for reliance on the internal control structure.
c. A requirement of the auditor's consideration of the internal control structure.
d. A desirable by-product of an audit engagement.

M89#7. Which of the following statements best describes how a detailed audit program of a CPA who is engaged to audit the financial statements of a large publicly held company compares with the audit client's comprehensive internal audit program?

a. The comprehensive internal audit program is substantially identical to the audit program used by the CPA because both cover substantially identical areas.
b. The comprehensive internal audit program is less detailed and covers fewer areas than would normally be covered by the CPA.
c. The comprehensive internal audit program is more detailed and covers areas that would normally **not** be covered by the CPA.
d. The comprehensive internal audit program is more detailed although it covers fewer areas than would normally be covered by the CPA.

N88#31. In evaluating internal accounting control, the auditor is basically concerned that the system provides reasonable assurance that

a. Operational efficiency has been achieved in accordance with management plans.
b. Errors and irregularities have been prevented or detected.
c. Controls have **not** been circumvented by collusion.
d. Management can **not** override the system.

N88#32. Proper segregation of functional responsibilities in an effective system of internal accounting control calls for separation of the functions of

a. Authorization, execution, and payment.
b. Authorization, recording, and custody.
c. Custody, execution, and reporting.
d. Authorization, payment, and recording.

N88#36. Which of the following characteristics distinguishes computer processing from manual processing?

a. Computer processing virtually eliminates the occurrence of computational error normally associated with manual processing.
b. Errors or irregularities in computer processing will be detected soon after their occurrences.
c. The potential for systematic error is ordinarily greater in manual processing than in computerized processing.
d. Most computer systems are designed so that transaction trails useful for audit purposes do **not** exist.

B. Consideration of the Internal Control Structure

M92#39. The diagram below depicts the auditor's estimated maximum deviation rate compared with the tolerable rate, and also depicts the true population deviation rate compared with the tolerable rate.

Auditor's estimate based on sample results	*True state of population* Deviation rate is less than tolerable rate	Deviation rate exceeds tolerable rate
Maximum deviation rate is less than tolerable rate	I.	III.
Maximum deviation rate exceeds tolerable rate	II.	IV.

As a result of tests of controls, the auditor assesses control risk higher than necessary and thereby increases substantive testing. This is illustrated by situation

a. I.
b. II.
c. III.
d. IV.

M92#40. As part of understanding the internal control structure, an auditor is **not** required to

a. Consider factors that affect the risk of material misstatement.
b. Ascertain whether internal control structure policies and procedures have been placed in operation.
c. Identify the types of potential misstatements that can occur.
d. Obtain knowledge about the operating effectiveness of the internal control structure.

M92#41. The primary objective of procedures performed to obtain an understanding of the internal control structure is to provide an auditor with

a. A basis for modifying tests of controls.
b. An evaluation of the consistency of application of management's policies.
c. Knowledge necessary for audit planning.
d. Evidential matter to use in assessing inherent risk.

M92#42. Which of the following is **not** a step in an auditor's decision to assess control risk at below the maximum?

a. Evaluate the effectiveness of the internal control procedures with tests of controls.
b. Obtain an understanding of the entity's accounting system and control environment.
c. Perform tests of details of transactions to detect material misstatements in the financial statements.
d. Consider whether control procedures can have a pervasive effect on financial statement assertions.

M92#43. In an audit of financial statements in accordance with generally accepted auditing standards, an auditor is required to

a. Perform tests of controls to evaluate the effectiveness of the entity's accounting system.
b. Determine whether control procedures are suitably designed to prevent or detect material misstatements.
c. Document the auditor's understanding of the entity's internal control structure.
d. Search for significant deficiencies in the operation of the internal control structure.

N91#34. After obtaining an understanding of the internal control structure and assessing control risk of an

entity, an auditor decided **not** to perform tests of controls. The auditor most likely decided that
- a. The available evidential matter obtained through tests of controls would **not** support an increased level of control risk.
- b. A reduction in the assessed level of control risk is justified for certain financial statement assertions.
- c. It would be inefficient to perform tests of controls that would result in a reduction in planned substantive tests.
- d. The assessed level of inherent risk exceeded the assessed level of control risk.

N91#35. An auditor would most likely be concerned with internal control structure policies and procedures that provide reasonable assurance about the
- a. Efficiency of management's decision-making process.
- b. Appropriate prices the entity should charge for its products.
- c. Methods of assigning production tasks to employees.
- d. Entity's ability to process and summarize financial data.

N91#36. Which of the following most likely represents a significant deficiency in the internal control structure?
- a. The systems analyst reviews applications of data processing and maintains systems documentation.
- b. The systems programmer designs systems for computerized applications and maintains output controls.
- c. The control clerk establishes control over data received by the EDP department and reconciles control totals after processing.
- d. The accounts payable clerk prepares data for computer processing and enters the data into the computer.

M91#25. Which of the following factors are included in an entity's control environment?

	Audit committee	*Internal audit function*	*Organizational structure*
a.	Yes	Yes	No
b.	Yes	No	Yes
c.	No	Yes	Yes
d.	Yes	Yes	Yes

M91#26. The acceptable level of detection risk is inversely related to the
- a. Assurance provided by substantive tests.
- b. Risk of misapplying auditing procedures.
- c. Preliminary judgment about materiality levels.
- d. Risk of failing to discover material misstatements.

M91#27. An auditor may decide to assess control risk at the maximum level for certain assertions because the auditor believes
- a. Sufficient evidential matter to support the assertions is likely to be available.
- b. Evaluating the effectiveness of policies and procedures is inefficient.
- c. More emphasis on tests of controls than substantive tests is warranted.
- d. Considering the relationship of assertions to specific account balances is more efficient.

N90#43. An auditor's primary consideration regarding an entity's internal control structure policies and procedures is whether they
- a. Prevent management override.
- b. Relate to the control environment.
- c. Reflect management's philosophy and operating style.
- d. Affect the financial statement assertions.

N90#44. In planning an audit of certain accounts, an auditor may conclude that specific procedures used to obtain an understanding of an entity's internal control structure need **not** be included because of the auditor's judgments about materiality and assessments of
- a. Control risk.
- b. Detection risk.
- c. Sampling risk.
- d. Inherent risk.

N90#45. To obtain evidential matter about control risk, an auditor ordinarily selects tests from a variety of techniques, including
- a. Analysis.
- b. Confirmation.
- c. Reperformance.
- d. Comparison.

N90#46. During consideration of the internal control structure in a financial statement audit, an auditor is **not** obligated to
- a. Search for significant deficiencies in the operation of the internal control structure.
- b. Understand the internal control environment and the accounting system.
- c. Determine whether the control procedures relevant to audit planning have been placed in operation.
- d. Perform procedures to understand the design of the internal control structure policies.

N90#47. When control risk is assessed at the maximum level for all financial statement assertions, an auditor should document the auditor's

	Understanding of the entity's internal control structure elements	*Conclusion that control risk is at the maximum level*	*Basis for concluding that control risk is at the maximum level*
a.	Yes	No	No
b.	Yes	Yes	No
c.	No	Yes	Yes
d.	Yes	Yes	Yes

M90#29. Which of the following elements of an entity's internal control structure includes the development of personnel manuals documenting employee promotion and training policies?
a. Control procedures.
b. Control environment.
c. Accounting system.
d. Quality control system.

M90#30. Which of the following statements about internal control structure is correct?
a. A properly maintained internal control structure reasonably ensures that collusion among employees cannot occur.
b. The establishment and maintenance of the internal control structure is an important responsibility of the internal auditor.
c. An exceptionally strong internal control structure is enough for the auditor to eliminate substantive tests on a significant account balance.
d. The cost-benefit relationship is a primary criterion that should be considered in designing an internal control structure.

M90#31. After obtaining an understanding of an entity's internal control structure, an auditor may assess control risk at the maximum level for some assertions because the auditor
a. Believes the internal control policies and procedures are unlikely to be effective.
b. Determines that the pertinent internal control structure elements are **not** well documented.
c. Performs tests of controls to restrict detection risk to an acceptable level.
d. Identifies internal control policies and procedures that are likely to prevent material misstatements.

M90#33. Which of the following audit techniques most likely would provide an auditor with the most assurance about the effectiveness of the operation of an internal control procedure?
a. Inquiry of client personnel.
b. Recomputation of account balance amounts.
c. Observation of client personnel.
d. Confirmation with outside parties.

N89#39. When obtaining an understanding of an entity's control environment, an auditor should concentrate on the substance of management's policies and procedures rather than their form because
a. The auditor may believe that the policies and procedures are inappropriate for that particular entity.
b. The board of directors may **not** be aware of management's attitude toward the control environment.
c. Management may establish appropriate policies and procedures but **not** act on them.
d. The policies and procedures may be so weak that **no** reliance is contemplated by the auditor.

N89#40. After obtaining an understanding of an entity's internal control structure and assessing control risk, an auditor may next
a. Perform tests of controls to verify management's assertions that are embodied in the financial statements.
b. Consider whether evidential matter is available to support a further reduction in the assessed level of control risk.
c. Apply analytical procedures as substantive tests to validate the assessed level of control risk.
d. Evaluate whether the internal control structure policies and procedures detected material misstatements in the financial statements.

N89#41. An auditor is **least** likely to test the internal controls that provide for
a. Approval of the purchase and sale of marketable securities.
b. Classification of revenue and expense transactions by product line.
c. Segregation of the functions of recording disbursements and reconciling the bank account.
d. Comparison of receiving reports and vendors' invoices with purchase orders.

N89#42. The possibility of erasing a large amount of information stored on magnetic tape most likely would be reduced by the use of
a. File protection rings.
b. Check digits.
c. Completeness tests.
d. Conversion verification.

M89#8. As a result of tests of controls, an auditor overrelied on internal control and decreased substantive testing. This overreliance occurred because the true deviation rate in the population was

a. Less than the risk of overreliance on the auditor's sample.
b. Less than the deviation rate in the auditor's sample.
c. More than the risk of overreliance on the auditor's sample.
d. More than the deviation rate in the auditor's sample.

M89#9. A procedure that would most likely be used by an auditor in performing tests of control procedures that involve segregation of functions and that leave **no** transaction trail is

a. Inspection.
b. Observation.
c. Reperformance.
d. Reconciliation.

M89#10. Which of the following is **not** a reason an auditor should obtain an understanding of the elements of an entity's internal control structure in planning an audit?

a. Identify the types of potential misstatements that can occur.
b. Design substantive tests.
c. Consider the operating effectiveness of the internal control structure.
d. Consider factors that affect the risk of material misstatements.

M89#11. Which of the following is **not** an element of an entity's internal control structure?

a. Control risk.
b. Control procedures.
c. The accounting system.
d. The control environment.

M89#12. Errors in data processed in a batch computer system may **not** be detected immediately because

a. Transaction trails in a batch system are available only for a limited period of time.
b. There are time delays in processing transactions in a batch system.
c. Errors in some transactions cause rejection of other transactions in the batch.
d. Random errors are more likely in a batch system than in an on-line system.

M89#13. When EDP programs or files can be accessed from terminals, users should be required to enter a(an)

a. Parity check.
b. Personal identification code.
c. Self-diagnosis test.
d. Echo check.

N88#34. When performing the review of an internal accounting control system's design, an auditor may obtain answers to an internal accounting control questionnaire. The next step ordinarily should be to

a. Make a preliminary evaluation of whether specific control procedures are suitably designed for reliance, assuming satisfactory compliance.
b. Perform compliance tests to provide reasonable assurance that the control procedures are being applied as prescribed.
c. Gather enough evidence to determine if the internal accounting control system is effective in preventing or detecting errors and irregularities.
d. Design substantive tests that do **not** contemplate reliance on the control procedures that appear to be ineffective.

N88#38. Which of the following would most likely be a weakness in the internal accounting control system of a client that utilizes microcomputers rather than a larger computer system?

a. Employee collusion possibilities are increased because microcomputers from one vendor can process the programs of a system from a different vendor.
b. The microcomputer operators may be able to remove hardware and software components and modify them at home.
c. Programming errors result in all similar transactions being processed incorrectly when those transactions are processed under the same conditions.
d. Certain transactions may be automatically initiated by the microcomputers and management's authorization of these transactions may be implicit in its acceptance of the system design.

N88#39. During the review of a small business client's internal accounting control system, the auditor discovered that the accounts receivable clerk approves credit memos and has access to cash. Which of the following controls would be most effective in offsetting this weakness?

a. The owner reviews errors in billings to customers and postings to the subsidiary ledger.
b. The controller receives the monthly bank statement directly and reconciles the checking accounts.
c. The owner reviews credit memos after they are recorded.
d. The controller reconciles the total of the detail accounts receivable accounts to the amount shown in the ledger.

N88#49. Which of the following conclusions could an auditor most likely make on completing the preliminary phase of the review of internal accounting control?

a. Specific control procedures are suitably designed for the auditor to rely on to restrict the extent of substantive tests, assuming satisfactory compliance.
b. The audit effort required to study and evaluate the design of the system exceeds the reduction in audit effort that could be achieved by reliance on the system.
c. The accounting control procedures are suitably designed to provide reasonable assurance that errors and irregularities will be prevented or detected, provided functions are properly segregated.
d. Compliance tests indicate that access to computer operations is so unrestricted that the internal accounting control system can **not** be relied on to restrict the extent of substantive tests.

M88#3. Which of the following statements is **not** true of the test data approach when testing a computerized accounting system?

a. The test data need consist of only those valid and invalid conditions which interest the auditor.
b. Only one transaction of each type need be tested.
c. The test data must consist of all possible valid and invalid conditions.
d. Test data are processed by the client's computer programs under the auditor's control.

M88#6. An auditor performs a test to determine whether all merchandise for which the client was billed was received. The population for this test consists of all

a. Merchandise received.
b. Vendors' invoices.
c. Canceled checks.
d. Receiving reports.

M88#7. Internal accounting control is ineffective when computer department personnel

a. Participate in computer software acquisition decisions.
b. Design documentation for computerized systems.
c. Originate changes in master files.
d. Provide physical security for program files.

M88#8. An auditor may compensate for a weakness in the internal accounting control system by increasing the

a. Level of detection risk.
b. Extent of compliance testing.
c. Preliminary judgment about audit risk.
d. Extent of analytical review procedures.

C. Cycles

M92#44. Tracing bills of lading to sales invoices provides evidence that

a. Shipments to customers were recorded as sales.
b. Recorded sales were shipped.
c. Invoiced sales were shipped.
d. Shipments to customers were invoiced.

M92#45. Which of the following controls most likely would be effective in offsetting the tendency of sales personnel to maximize sales volume at the expense of high bad debt write-offs?

a. Employees responsible for authorizing sales and bad debt write-offs are denied access to cash.
b. Shipping documents and sales invoices are matched by an employee who does **not** have authority to write off bad debts.
c. Employees involved in the credit-granting function are separated from the sales function.
d. Subsidiary accounts receivable records are reconciled to the control account by an employee independent of the authorization of credit.

M92#46. Which of the following questions would most likely be included in an internal control questionnaire concerning the completeness assertion for purchases?

a. Is an authorized purchase order required before the receiving department can accept a shipment or the vouchers payable department can record a voucher?
b. Are purchase requisitions prenumbered and independently matched with vendor invoices?
c. Is the unpaid voucher file periodically reconciled with inventory records by an employee who does **not** have access to purchase requisitions?
d. Are purchase orders, receiving reports, and vouchers prenumbered and periodically accounted for?

M92#47. Periodic or cycle counts of selected inventory items are made at various times during the year rather than a single inventory count at year end. Which of the following is necessary if the auditor plans to observe inventories at interim dates?

a. Complete recounts by independent teams are performed.
b. Perpetual inventory records are maintained.
c. Unit cost records are integrated with production accounting records.
d. Inventory balances are rarely at low levels.

M92#48. Which of the following control procedures most likely would assist in reducing control risk related to the existence or occurrence of manufacturing transactions?

a. Perpetual inventory records are independently compared with goods on hand.
b. Forms used for direct material requisitions are prenumbered and accounted for.
c. Finished goods are stored in locked limited-access warehouses.
d. Subsidiary ledgers are periodically reconciled with inventory control accounts.

M92#49. In meeting the control objective of safeguarding of assets, which department should be responsible for

	Distribution of paychecks	*Custody of unclaimed paychecks*
a.	Treasurer	Treasurer
b.	Payroll	Treasurer
c.	Treasurer	Payroll
d.	Payroll	Payroll

N91#38. Mailing disbursement checks and remittance advices should be controlled by the employee who

a. Approves the vouchers for payment.
b. Matches the receiving reports, purchase orders, and vendors' invoices.
c. Maintains possession of the mechanical checksigning device.
d. Signs the checks last.

N91#39. The safeguarding of inventory most likely includes

a. Comparison of the information contained on the purchase requisitions, purchase orders, receiving reports, and vendors' invoices.
b. Periodic reconciliation of detailed inventory records with the actual inventory on hand by taking a physical count.
c. Analytical procedures for raw materials, goods in process, and finished goods that identify unusual transactions, theft, and obsolescence.
d. Application of established overhead rates on the basis of direct labor hours or direct labor costs.

N91#40. The purpose of segregating the duties of hiring personnel and distributing payroll checks is to separate the

a. Authorization of transactions from the custody of related assets.
b. Operational responsibility from the record keeping responsibility.
c. Human resources function from the controllership function.
d. Administrative controls from the internal accounting controls.

N91#41. Immediately upon receipt of cash, a responsible employee should

a. Record the amount in the cash receipts journal.
b. Prepare a remittance listing.
c. Update the subsidiary accounts receivable records.
d. Prepare a deposit slip in triplicate.

M91#28. An auditor would consider a cashier's job description to contain compatible duties if the cashier receives remittances from the mailroom and also prepares the

a. Prelist of individual checks.
b. Monthly bank reconciliation.
c. Daily deposit slip.
d. Remittance advices.

M91#29. Which of the following most likely would be an internal control procedure designed to detect errors and irregularities concerning the custody of inventory?

a. Periodic reconciliation of work in process with job cost sheets.
b. Segregation of functions between general accounting and cost accounting.
c. Independent comparisons of finished goods records with counts of goods on hand.
d. Approval of inventory journal entries by the storekeeper.

M91#30. Sound internal control procedures dictate that defective merchandise returned by customers should be presented initially to the

a. Sales clerk.
b. Purchasing clerk.
c. Receiving clerk.
d. Inventory control clerk.

M91#31. In a computerized payroll system environment, an auditor would be **least** likely to use test data to test controls related to

a. Missing employee numbers.
b. Proper approval of overtime by supervisors.
c. Time tickets with invalid job numbers.
d. Agreement of hours per clock cards with hours on time tickets.

M91#32. The primary responsibility of a bank acting as registrar of capital stock is to

a. Ascertain that dividends declared do **not** exceed the statutory amount allowable in the state of incorporation.
b. Account for stock certificates by comparing the total shares outstanding to the total in the shareholders subsidiary ledger.
c. Act as an independent third party between the board of directors and outside investors concerning mergers, acquisitions, and the sale of treasury stock.
d. Verify that stock is issued in accordance with the authorization of the board of directors and the articles of incorporation.

N90#48. The most likely result of ineffective internal control policies and procedures in the revenue cycle is that

a. Irregularities in recording transactions in the subsidiary accounts could result in a delay in goods shipped.
b. Omission of shipping documents could go undetected, causing an understatement of inventory.
c. Final authorization of credit memos by personnel in the sales department could permit an employee defalcation scheme.
d. Fictitious transactions could be recorded, causing an understatement of revenues and overstatement of receivables.

N90#49. Proper authorization procedures in the revenue cycle usually provide for the approval of bad debt write-offs by an employee in which of the following departments?

a. Treasurer.
b. Sales.
c. Billing.
d. Accounts receivable.

N90#50. An auditor wishes to perform tests of controls on a client's cash disbursements procedures. If the control procedures leave **no** audit trail of documentary evidence, the auditor most likely will test the procedures by

a. Inquiry and analytical procedures.
b. Confirmation and observation.
c. Observation and inquiry.
d. Analytical procedures and confirmation.

N90#51. Which of the following controls would be most effective in assuring that recorded purchases are free of material errors?

a. The receiving department compares the quantity ordered on purchase orders with the quantity received on receiving reports.
b. Vendors' invoices are compared with purchase orders by an employee who is independent of the receiving department.
c. Receiving reports require the signature of the individual who authorized the purchase.
d. Purchase orders, receiving reports, and vendors' invoices are independently matched in preparing vouchers.

N90#52. The objectives of the internal control structure for a production cycle are to provide assurance that transactions are properly executed and recorded, and that

a. Independent internal verification of activity reports is established.
b. Transfers to finished goods are documented by a completed production report and a quality control report.
c. Production orders are prenumbered and signed by a supervisor.
d. Custody of work in process and of finished goods is properly maintained.

N90#53. Effective internal control procedures over the payroll function may include

a. Reconciliation of totals on job time tickets with job reports by employees responsible for those specific jobs.
b. Verification of agreement of job time tickets with employee clock card hours by a payroll department employee.
c. Preparation of payroll transaction journal entries by an employee who reports to the supervisor of the personnel department.
d. Custody of rate authorization records by the supervisor of the payroll department.

N90#54. Which of the following controls would be most effective in assuring that the proper custody of assets in the investing cycle is maintained?

a. Direct access to securities in the safety deposit box is limited to only one corporate officer.
b. Personnel who post investment transactions to the general ledger are **not** permitted to update the investment subsidiary ledger.
c. The purchase and sale of investments are executed on the specific authorization of the board of directors.
d. The recorded balances in the investment subsidiary ledger are periodically compared with the contents of the safety deposit box by independent personnel.

M90#35. Employers bond employees who handle cash receipts because fidelity bonds reduce the possibility of employing dishonest individuals and

a. Protect employees who make unintentional errors from possible monetary damages resulting from their errors.
b. Deter dishonesty by making employees aware that insurance companies may investigate and prosecute dishonest acts.
c. Facilitate an independent monitoring of the receiving and depositing of cash receipts.
d. Force employees in positions of trust to take periodic vacations and rotate their assigned duties.

M90#36. To determine whether accounts payable are complete, an auditor performs a test to verify that all merchandise received is recorded. The population of documents for this test consists of all

a. Vendor's invoices.
b. Purchase orders.
c. Receiving reports.
d. Canceled checks.

M90#37. Which of the following control procedures is **not** usually performed in the vouchers payable department?

a. Determining the mathematical accuracy of the vendor's invoice.
b. Having an authorized person approve the voucher.
c. Controlling the mailing of the check and remittance advice.
d. Matching the receiving report with the purchase order.

M90#38. Which of the following internal control procedures most likely addresses the completeness assertion for inventory?

a. Work in process account is periodically reconciled with subsidiary records.
b. Employees responsible for custody of finished goods do **not** perform the receiving function.
c. Receiving reports are prenumbered and periodically reconciled.
d. There is a separation of duties between payroll department and inventory accounting personnel.

M90#39. The sampling unit in a test of controls pertaining to the existence of payroll transactions ordinarily is a(an)

a. Clock card or time ticket.
b. Employee Form W-2.
c. Employee personnel record.
d. Payroll register entry.

N89#45. An internal control narrative indicates that an approved voucher is required to support every check request for payment of merchandise. Which of the following procedures provides the greatest assurance that this control is operating effectively?

a. Select and examine vouchers and ascertain that the related cancelled checks are dated **no** later than the vouchers.
b. Select and examine vouchers and ascertain that the related cancelled checks are dated **no** earlier than the vouchers.
c. Select and examine cancelled checks and ascertain that the related vouchers are dated **no** earlier than the checks.
d. Select and examine cancelled checks and ascertain that the related vouchers are dated **no** later than the checks.

N89#46. For effective internal control purposes, the vouchers payable department generally should

a. Stamp, perforate, or otherwise cancel supporting documentation after payment is mailed.
b. Ascertain that each requisition is approved as to price, quantity, and quality by an authorized employee.
c. Obliterate the quantity ordered on the receiving department copy of the purchase order.
d. Establish the agreement of the vendor's invoice with the receiving report and purchase order.

N89#47. An auditor's tests of controls over the issuance of raw materials to production would most likely include

a. Reconciling raw materials and work in process perpetual inventory records to general ledger balances.
b. Inquiring of the custodian about the procedures followed when defective materials are received from vendors.
c. Observing that raw materials are stored in secure areas and that storeroom security is supervised by a responsible individual.
d. Examining material requisitions and reperforming client controls designed to process and record issuances.

N89#48. A weakness in internal control over recording retirements of equipment may cause an auditor to

a. Trace additions to the "other assets" account to search for equipment that is still on hand but **no** longer being used.
b. Select certain items of equipment from the accounting records and locate them in the plant.
c. Inspect certain items of equipment in the plant and trace those items to the accounting records.
d. Review the subsidiary ledger to ascertain whether depreciation was taken on each item of equipment during the year.

M89#14. When goods are received, the receiving clerk should match the goods with the

a. Purchase order and the requisition form.
b. Vendor's invoice and the receiving report.
c. Vendor's shipping document and the purchase order.
d. Receiving report and the vendor's shipping document.

M89#18. Independent internal verification of inventory occurs when employees who

a. Issue raw materials obtain material requisitions for each issue and prepare daily totals of materials issued.
b. Compare records of goods on hand with physical quantities do **not** maintain the records or have custody of the inventory.
c. Obtain receipts for the transfer of completed work to finished goods prepare a completed production report.
d. Are independent of issuing production orders update records from completed job cost sheets and production cost reports on a timely basis.

M89#19. When there are numerous property and equipment transactions during the year, an auditor planning to assess control risk at the minimum level usually plans to obtain an understanding of the internal control structure and to perform

a. Tests of controls and extensive tests of property and equipment balances at the end of the year.
b. Extensive tests of current year property and equipment transactions.
c. Tests of controls and limited tests of current year property and equipment transactions.
d. Analytical procedures for property and equipment balances at the end of the year.

N88#40. At which point in an ordinary sales transaction of a wholesaling business would a lack of specific authorization **least** concern the auditor conducting an audit?

a. Determining discounts.
b. Selling goods for cash.
c. Granting credit.
d. Shipping goods.

N88#41. Cash receipts from sales on account have been misappropriated. Which of the following acts would conceal this defalcation and be **least** likely to be detected by an auditor?

a. Understating the sales journal.
b. Overstating the accounts receivable control account.
c. Overstating the accounts receivable subsidiary ledger.
d. Understating the cash receipts journal.

N88#42. For effective internal accounting control, the accounts payable department should compare the information on each vendor's invoice with the

a. Receiving report and the purchase order.
b. Receiving report and the voucher.
c. Vendor's packing slip and the purchase order.
d. Vendor's packing slip and the voucher.

N88#43. Which of the following is the most effective control procedure to detect vouchers that were prepared for the payment of goods that were **not** received?

a. Count goods upon receipt in storeroom.
b. Match purchase order, receiving report, and vendor's invoice for each voucher in accounts payable department.
c. Compare goods received with goods requisitioned in receiving department.
d. Verify vouchers for accuracy and approval in internal audit department.

N88#44. Which of the following control procedures would most likely be used to maintain accurate perpetual inventory records?

a. Independent storeroom count of goods received.
b. Periodic independent reconciliation of control and subsidiary records.
c. Periodic independent comparison of records with goods on hand.
d. Independent matching of purchase orders, receiving reports, and vendors' invoices.

N88#45. If a control total were to be computed on each of the following data items, which would best be identified as a hash total for a payroll EDP application?

a. Hours worked.
b. Total debits and total credits.
c. Net pay.
d. Department numbers.

N88#46. Which of the following procedures is most likely to prevent the improper disposition of equipment?

a. A separation of duties between those authorized to dispose of equipment and those authorized to approve removal work orders.
b. The use of serial numbers to identify equipment that could be sold.
c. Periodic comparison of removal work orders to authorizing documentation.
d. A periodic analysis of the scrap sales and the repairs and maintenance accounts.

M88#9. Internal accounting control is strengthened when the quantity of merchandise ordered is omitted from the copy of the purchase order sent to the

a. Department that initiated the requisition.
b. Receiving department.
c. Purchasing agent.
d. Accounts payable department.

M88#10. Property acquisitions that are misclassified as maintenance expense would most likely be detected by an internal accounting control system that provides for

a. Investigation of variances within a formal budgeting system.
b. Review and approval of the monthly depreciation entry by the plant supervisor.
c. Segregation of duties of employees in the accounts payable department.
d. Examination by the internal auditor of vendor invoices and canceled checks for property acquisitions.

M88#20. Which of the following procedures in the cash disbursements cycle should **not** be performed by the accounts payable department?

a. Comparing the vendor's invoice with the receiving report.
b. Canceling supporting documentation after payment.
c. Verifying the mathematical accuracy of the vendor's invoice.
d. Signing the voucher for payment by an authorized person.

D. Other Considerations

M92#50. Reportable conditions are matters that come to an auditor's attention that should be communicated to an entity's audit committee because they represent

a. Manipulation or falsification of accounting records or documents from which financial statements are prepared.
b. Disclosures of information that significantly contradict the auditor's going concern assumption.
c. Material irregularities or illegal acts perpetrated by high-level management.
d. Significant deficiencies in the design or operation of the internal control structure.

M92#51. Which of the following statements concerning an auditor's communication of reportable conditions is correct?

a. The auditor should request a meeting with management one level above the source of the reportable conditions to discuss suggestions for remedial action.
b. Any report issued on reportable conditions should indicate that providing assurance on the internal control structure was **not** the purpose of the audit.
c. Reportable conditions discovered and communicated at an interim date should be reexamined with tests of controls before completing the engagement.
d. Suggestions concerning administration efficiencies and business strategies should **not** be communicated in the same report with reportable conditions.

M92#52. An accountant's report expressing an opinion on an entity's internal controls should state that

a. Only those controls on which the accountant intends to rely were reviewed, tested, and evaluated.
b. The establishment and maintenance of the internal controls is the responsibility of management.
c. The study and evaluation of the internal controls was conducted in accordance with generally accepted auditing standards.
d. Distribution of the report is restricted for use only by management and the board of directors.

M92#53. Which of the following statements is correct concerning statistical sampling in tests of controls?

a. Deviations from control procedures at a given rate usually result in misstatements at a higher rate.
b. As the population size doubles, the sample size should also double.
c. The qualitative aspects of deviations are **not** considered by the auditor.
d. There is an inverse relationship between the sample size and the tolerable rate.

M92#54. What is an auditor's evaluation of a statistical sample for attributes when a test of 50 documents results in 3 deviations if tolerable rate is 7%, the expected population deviation rate is 5%, and the allowance for sampling risk is 2%.

a. Modify the planned assessed level of control risk because the tolerable rate plus the allowance for sampling risk exceeds the expected population deviation rate.
b. Accept the sample results as support for the planned assessed level of control risk because the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate.
c. Accept the sample results as support for the planned assessed level of control risk because the tolerable rate less the allowance for sampling risk equals the expected population deviation rate.
d. Modify the planned assessed level of control risk because the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate.

M92#55. Decision tables differ from program flowcharts in that decision tables emphasize

a. Ease of manageability for complex programs.
b. Logical relationships among conditions and actions.
c. Cost benefit factors justifying the program.
d. The sequence in which operations are performed.

N91#43. Which of the following statements is correct concerning reportable conditions noted in an audit?

a. Reportable conditions are material weaknesses in the design or operation of specific internal control structure elements.
b. The auditor is obligated to search for reportable conditions that could adversely affect the entity's ability to record and report financial data.
c. Reportable conditions should be recommunicated each year, even if management has acknowledged its understanding of such deficiencies.
d. The auditor may separately communicate those reportable conditions considered to be material weaknesses.

M91#33. An auditor's communication of internal control structure related matters noted in an audit usually should be addressed to the

a. Audit committee.
b. Director of internal auditing.
c. Chief financial officer.
d. Chief accounting officer.

M91#34. When reporting on conditions relating to an entity's internal control structure observed during an audit of the financial statements, the auditor should include a

a. Description of tests performed to search for material weaknesses.
b. Statement of positive assurance on the structure.
c. Paragraph describing the inherent limitations of the structure.
d. Restriction on the distribution of the report.

M91#35. A previously communicated reportable condition that has not been corrected ordinarily should be communicated again if

a. The deficiency has a material effect on the auditor's assessment of control risk.
b. The entity accepts that degree of risk because of cost-benefit considerations.
c. The weakness could adversely affect the entity's ability to report financial data.
d. There has been major turnover in upper-level management and the board of directors.

M91#36. An accountant's report expressing an unqualified opinion on an entity's system of internal accounting control should contain a

a. Description of the difference between the expression of an opinion on the system and the assessment of control risk made as part of an audit.
b. Statement that the establishment and maintenance of the system is the responsibility of management.
c. Statement that the distribution of the accountant's report is limited to the entity's management and its board of directors.
d. Description of the material weaknesses that may permit errors or irregularities to occur and **not** be detected.

M91#37. An engagement to express an opinion on a system of internal accounting control will generally

a. Require procedures that duplicate those already applied in assessing control risk during a financial statement audit.
b. Increase the reliability of the financial statements that have already been audited.
c. Be more extensive in scope than the assessment of control risk made during a financial statement audit.
d. Be more limited in scope than the assessment of control risk made during a financial statement audit.

M91#39. In performing tests of controls over authorization of cash disbursements, which of the following sampling methods would be most appropriate?

a. Ratio.
b. Attributes.
c. Variables.
d. Stratified.

M91#40. Samples to test internal control structure procedures are intended to provide a basis for an auditor to conclude whether

a. The control procedures are operating effectively.
b. The financial statements are materially misstated.
c. The risk of incorrect acceptance is too high.
d. Materiality for planning purposes is at a sufficiently low level.

M91#47. The GAO standards of reporting for governmental financial audits incorporate the AICPA standards of reporting and prescribe supplemental standards to satisfy the unique needs of governmental audits. Which of the following is a supplemental reporting standard for government financial audits?

a. A written report on the auditor's understanding of the entity's internal control structure and assessment of control risk should be prepared.
b. Material indications of illegal acts should be reported in a document with distribution restricted to senior officials of the entity audited.
c. Instances of abuse, fraud, mismanagement, and waste should be reported to the organization with legal oversight authority over the entity audited.
d. All privileged and confidential information discovered should be reported to the senior officials of the organization that arranged for the audit.

N90#55. Which of the following statements concerning material weaknesses and reportable conditions is correct?

a. An auditor should identify and communicate material weaknesses separately from reportable conditions.
b. All material weaknesses are reportable conditions.
c. An auditor should report immediately material weaknesses and reportable conditions discovered during an audit.
d. All reportable conditions are material weaknesses.

N90#56. An accountant's report expressing an unqualified opinion on an entity's system of internal accounting control should state that the

a. Engagement is different in purpose and scope from obtaining an understanding of the internal control structure and assessing control risk as part of an audit.
b. Accountant's opinion does **not** necessarily increase the reliability of the entity's financial statements unless they are audited.

c. System taken as a whole is sufficient to meet the broad objectives pertaining to preventing or detecting material errors or irregularities.
d. Accountant did **not** apply procedures in the engagement that duplicate those procedures previously applied in assessing control risk as part of an audit.

N90#57. Cain Company's management engaged Bell, CPA, to express an opinion on Cain's system of internal accounting control. Bell's report described several material weaknesses and potential errors and irregularities that could occur. Subsequently, management included Bell's report in its annual report to the Board of Directors with a statement that the cost of correcting the weaknesses would exceed the benefits. Bell should
a. Not express an opinion as to management's cost-benefit statement.
b. Advise the Board that Bell either agrees or disagrees with management's statement.
c. Advise management that Bell's report was restricted for use only by management.
d. Advise both management and the Board that Bell was withdrawing the opinion.

N90#58. To determine the sample size for a test of controls, an auditor should consider the tolerable deviation rate, the allowable risk of assessing control risk too low, and the
a. Expected deviation rate.
b. Upper precision limit.
c. Risk of incorrect acceptance.
d. Risk of incorrect rejection.

N90
Items 59 and 60 are based on the following:

An auditor desired to test credit approval on 10,000 sales invoices processed during the year. The auditor designed a statistical sample that would provide 1% risk of assessing control risk too low (99% confidence) that not more than 7% of the sales invoices lacked approval. The auditor estimated from previous experience that about 2½% of the sales invoices lacked approval. A sample of 200 invoices was examined and 7 of them were lacking approval. The auditor then determined the achieved upper precision limit to be 8%.

59. In the evaluation of this sample, the auditor decided to increase the level of the preliminary assessment of control risk because the
a. Tolerable rate (7%) was less than the achieved upper precision limit (8%).
b. Expected deviation rate (7%) was more than the percentage of errors in the sample (3½%).
c. Achieved upper precision limit (8%) was more than the percentage of errors in the sample (3½%).
d. Expected deviation rate (2½%) was less than the tolerable rate (7%).

60. The allowance for sampling risk was
a. 5½%
b. 4½%
c. 3½%
d. 1 %

M90#40. How do the scope, procedures, and purpose of an engagement to express an opinion on an entity's system of internal accounting control compare to those for obtaining an understanding of the internal control structure and assessing control risk as part of an audit?

	Scope	*Procedures*	*Purpose*
a.	Similar	Different	Similar
b.	Different	Similar	Similar
c.	Different	Different	Different
d.	Different	Similar	Different

M90#41. When engaged to express an opinion on an entity's system of internal accounting control, an accountant should
a. Obtain management's written representations acknowledging responsibility for establishing and maintaining the system.
b. Qualify any opinion concerning management's assertion that the cost of correcting any weaknesses exceeds the benefits.
c. Keep informed of events subsequent to the date of the report that might have affected the accountant's opinion.
d. Disclaim an opinion on whether the system taken as a whole is sufficient to prevent or detect material errors or irregularities.

M90#42. The likelihood of assessing control risk too high is the risk that the sample selected to test controls
a. Does **not** support the tolerable error for some or all of management's assertions.
b. Does **not** support the auditor's planned assessed level of control risk when the true operating effectiveness of the control structure justifies such an assessment.
c. Contains misstatements that could be material to the financial statements when aggregated with misstatements in other account balances or transaction classes.
d. Contains proportionately fewer monetary errors or deviations from prescribed internal control structure policies or procedures than exist in the balance or class as a whole.

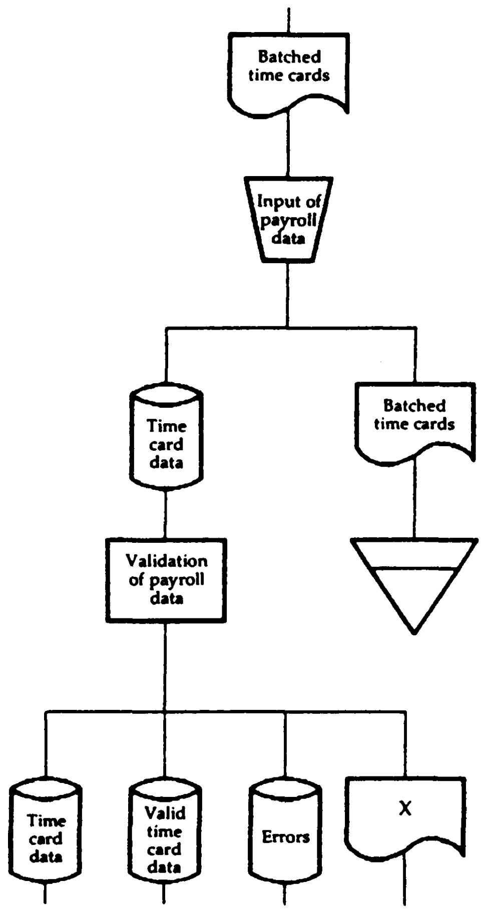
M90#43. An auditor is testing internal control procedures that are evidenced on an entity's vouchers by matching random numbers with voucher numbers. If a random number matches the number of a voided voucher, that voucher ordinarily should be replaced by another voucher in the random sample if the voucher

a. Constitutes a deviation.
b. Has been properly voided.
c. Cannot be located.
d. Represents an immaterial dollar amount.

M90#44. The risk of incorrect acceptance and the likelihood of assessing control risk too low relate to the

a. Effectiveness of the audit.
b. Efficiency of the audit.
c. Preliminary estimates of materiality levels.
d. Allowable risk of tolerable error.

M90
Item 45 is based on the following section of a system flowchart for a payroll application



45. Symbol X could represent

a. Erroneous time cards.
b. An error report.
c. Batched time cards.
d. Unclaimed payroll checks.

N89#50. An accountant's report expressing an opinion on an entity's internal controls should

a. Briefly explain the broad objectives and inherent limitations of internal control.
b. State that the study and evaluation of the internal controls was conducted in accordance with generally accepted auditing standards.
c. Clearly disclaim responsibility for the establishment and maintenance of the internal controls.
d. Include an opinion concerning management's assertions about whether the cost of correcting any material weaknesses would exceed the benefits of reducing the risk of errors and irregularities.

N89#51. An accountant has been engaged to report on an entity's internal controls without performing an audit of the financial statements. What restrictions, if any, should the accountant place on the use of this report?

a. This report should be restricted for use by management.
b. This report should be restricted for use by the audit committee.
c. This report should be restricted for use by a specified regulatory agency.
d. The accountant does **not** need to place any restrictions on the use of this report.

N89#52. Which of the following combinations results in a decrease in sample size in a sample for attributes?

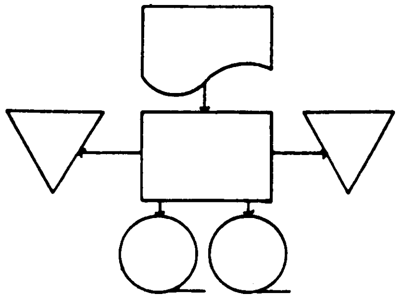
	Risk of overreliance	*Tolerable rate*	*Expected population deviation rate*
a.	Increase	Decrease	Increase
b.	Decrease	Increase	Decrease
c.	Increase	Increase	Decrease
d.	Increase	Increase	Increase

N89#54. A principal advantage of statistical methods of attribute sampling over nonstatistical methods is that they provide a scientific basis for planning the

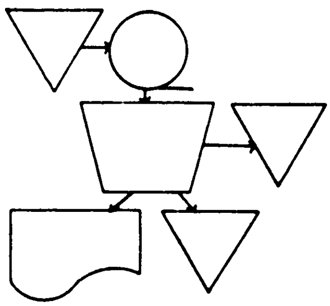
a. Risk of overreliance.
b. Tolerable rate.
c. Expected population deviation rate.
d. Sample size.

N89#55. Which of the following symbolic representations indicates that new payroll transactions and the old payroll file have been used to prepare payroll checks, prepare a printed payroll journal, and generate a new payroll file?

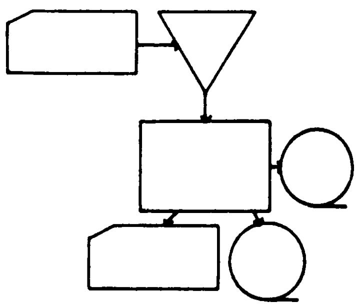
a.



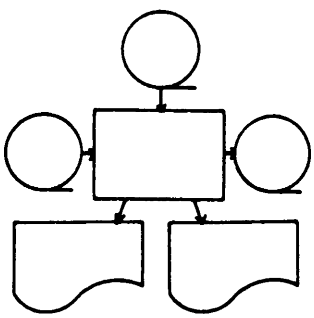
b.



c.



d.



M89#20. Which of the following statements is correct concerning an auditor's communication of internal control structure related matters (reportable conditions) noted in an audit?

a. The auditor may issue a written report to the audit committee representing that **no** reportable conditions were noted during the audit.
b. Reportable conditions should be recommunicated each year even if the audit committee has acknowledged its understanding of such deficiencies.
c. Reportable conditions may **not** be communicated in a document that contains suggestions regarding activities that concern other topics such as business strategies or administrative efficiencies.
d. The auditor may choose to communicate significant internal control structure related matters either during the course of the audit or after the audit is concluded.

M89#21. An accountant's report expressing an opinion on an entity's internal controls should contain a

a. Statement that the entity's internal controls are consistent with that of the prior year after giving effect to subsequent changes.
b. Brief explanation of the broad objectives and inherent limitations of internal control.
c. Description of the principal controls that protect assets against loss from unauthorized use or disposition.
d. Statement that the engagement was conducted in accordance with generally accepted auditing standards.

M89#22. An independent accountant, without auditing an entity's financial statements, may accept an engagement to express an opinion on the entity's internal controls in effect

	As of a specified date	*During a specified period of time*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M89#23. An auditor who uses statistical sampling for attributes in testing internal controls should reduce the planned reliance on a prescribed control when the

a. Sample rate of deviation is less than the expected rate of deviation used in planning the sample.
b. Tolerable rate less the allowance for sampling risk exceeds the sample rate of deviation.
c. Sample rate of deviation plus the allowance for sampling risk exceeds the tolerable rate.
d. Sample rate of deviation plus the allowance for sampling risk equals the tolerable rate.

M89#24. Which of the following factors is generally **not** considered in determining the sample size for a test of controls?

a. Population size.
b. Tolerable rate.
c. Risk of overreliance.
d. Expected population deviation rate.

M89#25. An advantage of using statistical over nonstatistical sampling methods in tests of controls is that the statistical methods

a. Afford greater assurance than a nonstatistical sample of equal size.
b. Provide an objective basis for quantitatively evaluating sample risks.

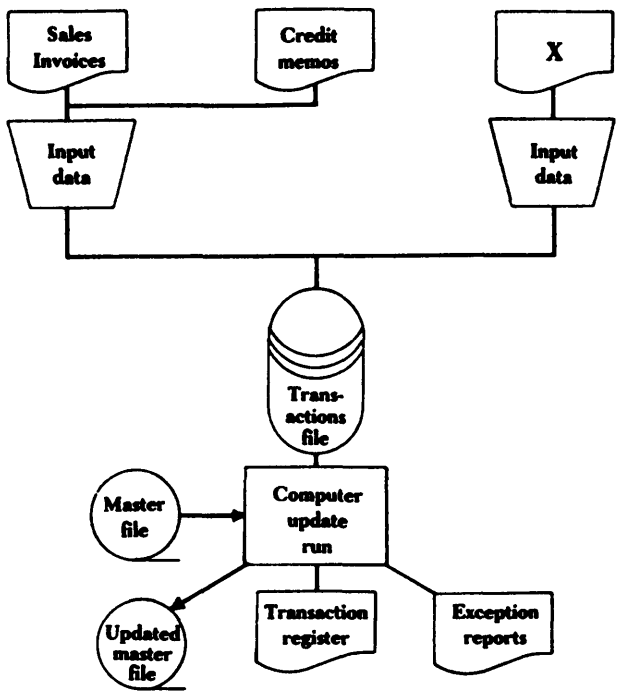
c. Can more easily convert the sample into a dual-purpose test useful for substantive testing.
d. Eliminate the need to use judgment in determining appropriate sample sizes.

N88#35. An auditor's study and evaluation of the internal accounting control system made in connection with an annual audit is usually **not** sufficient to express an opinion on an entity's system because
a. The evaluation of weaknesses is subjective enough that an auditor should **not** express an opinion on the internal accounting controls alone.
b. The audit cost-benefit relationship permits an auditor to express only reasonable assurance that the system operates as designed.
c. Management may change the internal accounting controls to correct weaknesses.
d. Only those controls on which an auditor intends to rely are reviewed, tested, and evaluated.

N88#47. Which of the following statements is correct concerning the auditor's required communication of a material weakness in internal accounting control?
a. A weakness that management refuses to correct should be included in a separate paragraph of the auditor's report.
b. A weakness previously communicated during the prior year's audit that has **not** been corrected should be communicated again in writing.
c. Suggested corrective action for management's consideration concerning a weakness need **not** be communicated to the client.
d. The auditor should test for compliance any weakness discovered before communicating it to the client.

N88#48. A CPA has performed an examination of the general purpose financial statements of Big City. The examination scope included the additional requirements of the Single Audit Act. When reporting on Big City's internal accounting and administrative controls used in administering a federal financial assistance program, the CPA should
a. Communicate those weaknesses that are material in relation to the general purpose financial statements.
b. Express an opinion on the systems used to administer major federal financial assistance programs and express negative assurance on the systems used to administer nonmajor federal financial assistance programs.
c. Communicate those weaknesses that are material in relation to the federal financial assistance program.
d. Express negative assurance on the systems used to administer major federal financial assistance programs and express **no** opinion on the systems used to administer nonmajor federal financial assistance programs.

N88
Item 60 is based on the following flowchart:



60. In a credit sales and cash receipts system flowchart symbol X could represent
a. Auditor's test data.
b. Remittance advices.
c. Error reports.
d. Credit authorization forms.

M88#15. A CPA's report expressing an opinion on an entity's internal accounting control system identified several material weaknesses and will be published in the entity's annual report to shareholders. Management intends to include a statement asserting that the cost of correcting the weaknesses would exceed the benefits of reducing the risk of errors and irregularities. The CPA should
a. Insist that management's statement **not** appear in the same document as the CPA's report.
b. Investigate whether the cost of correcting the weaknesses would, in fact, exceed the benefits.
c. Insist that management correct the weaknesses if cost is the only consideration.
d. Not express any opinion as to management's statement.

III. Evidence and Procedures

A. Audit Evidence

M92#13. "There have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements." The foregoing passage is most likely from a

a. Special report.
b. Management representation letter.
c. Letter for an underwriter.
d. Report on internal controls.

M92#16. Which of the following statements is generally correct about the competence of evidential matter?

a. The more effective the internal control structure, the more assurance it provides about the reliability of the accounting data and financial statements.
b. Competence of evidential matter refers to the amount of corroborative evidence obtained.
c. Information obtained indirectly from independent outside sources is more persuasive than the auditor's direct personal knowledge obtained through observation and inspection.
d. Competence of evidential matter refers to the audit evidence obtained from outside the entity.

M92#17. Which of the following audit procedures probably would provide the most reliable evidence concerning the entity's assertion of rights and obligations related to inventories?

a. Trace test counts noted during the entity's physical count to the entity's summarization of quantities.
b. Inspect agreements to determine whether any inventory is pledged as collateral or subject to any liens.
c. Select the last few shipping advices used before the physical count and determine whether the shipments were recorded as sales.
d. Inspect the open purchase order file for significant commitments that should be considered for disclosure.

M92#18. During an audit of an entity's stockholders' equity accounts, the auditor determines whether there are restrictions on retained earnings resulting from loans, agreements, or state law. This audit procedure most likely is intended to verify management's assertion of

a. Existence or occurrence.
b. Completeness.
c. Valuation or allocation.
d. Presentation and disclosure.

M92#19. Which of the following most likely would give the most assurance concerning the valuation assertion of accounts receivable?

a. Tracing amounts in the subsidiary ledger to details on shipping documents.
b. Comparing receivable turnover ratios to industry statistics for reasonableness.
c. Inquiring about receivables pledged under loan agreements.
d. Assessing the allowance for uncollectible accounts for reasonableness.

M92#20. Which of the following tends to be most predictable for purposes of analytical procedures applied as substantive tests?

a. Relationships involving balance sheet accounts.
b. Transactions subject to management discretion.
c. Relationships involving income statement accounts.
d. Data subject to audit testing in the prior year.

M92#22. When using the work of a specialist, an auditor may refer to and identify the specialist in the auditor's report if the

a. Auditor expresses a qualified opinion as a result of the specialist's findings.
b. Specialist is **not** independent of the client.
c. Auditor wishes to indicate a division of responsibility.
d. Specialist's work provides the auditor greater assurance of reliability.

M92#23. An auditor should request that an audit client send a letter of inquiry to those attorneys who have been consulted concerning litigation, claims, or assessments. The primary reason for this request is to provide

a. The opinion of a specialist as to whether loss contingencies are possible, probable, or remote.
b. A description of litigation, claims, and assessments that have a reasonable possibility of unfavorable outcomes.
c. An objective appraisal of management's policies and procedures adopted for identifying and evaluating legal matters.
d. The corroboration of the information furnished by management concerning litigation, claims, and assessments.

N91#37. As the acceptable level of detection risk decreases, the assurance directly provided from

a. Substantive tests should increase.
b. Substantive tests should decrease.
c. Tests of controls should increase.
d. Tests of controls should decrease.

N91#42. Which of the following statements concerning analytical procedures is correct?
a. Analytical procedures may be omitted entirely for some financial statement audits.
b. Analytical procedures used in planning the audit should **not** use nonfinancial information.
c. Analytical procedures usually are effective and efficient for tests of controls.
d. Analytical procedures alone may provide the appropriate level of assurance for some assertions.

N91#44. To satisfy the valuation assertion when auditing an investment accounted for by the equity method, an auditor most likely would
a. Inspect the stock certificates evidencing the investment.
b. Examine the audited financial statements of the investee company.
c. Review the broker's advice or canceled check for the investment's acquisition.
d. Obtain market quotations from financial newspapers or periodicals.

N91#45. Cutoff tests designed to detect credit sales made before the end of the year that have been recorded in the subsequent year provide assurance about management's assertion of
a. Presentation.
b. Completeness.
c. Rights.
d. Existence.

N91#46. Inquiries of warehouse personnel concerning possible obsolete or slow-moving inventory items provide assurance about management's assertion of
a. Completeness.
b. Existence.
c. Presentation.
d. Valuation.

N91#47. The objective of tests of details of transactions performed as substantive tests is to
a. Detect material misstatements in the financial statements.
b. Evaluate whether management's policies and procedures operated effectively.
c. Identify specific financial statement assertions that satisfy the audit objectives.
d. Verify that significant deficiencies in the accounting system are discovered.

N91#48. An auditor's analytical procedures most likely would be facilitated if the entity
a. Corrects material weaknesses in internal control before the beginning of the audit.
b. Develops its data from sources solely within the entity.
c. Segregates obsolete inventory before the physical inventory count.
d. Uses a standard cost system that produces variance reports.

N91#60. Which of the following is **not** an audit procedure that the independent auditor would perform concerning litigation, claims, and assessments?
a. Obtain assurance from management that it has disclosed all unasserted claims that the lawyer has advised are probable of assertion and must be disclosed.
b. Confirm directly with the client's lawyer that all claims have been recorded in the financial statements.
c. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
d. Obtain from management a description and evaluation of litigation, claims, and assessments existing at the balance sheet date.

M91#1. Which of the following statements concerning evidential matter is correct?
a. Competent evidence supporting management's assertions should be convincing rather than merely persuasive.
b. An effective internal control structure contributes little to the reliability of the evidence created within the entity.
c. The cost of obtaining evidence is **not** an important consideration to an auditor in deciding what evidence should be obtained.
d. A client's accounting data **cannot** be considered sufficient audit evidence to support the financial statements.

M91#2. An auditor's purpose in reviewing credit ratings of customers with delinquent accounts receivable most likely is to obtain evidence concerning management's assertions about
a. Presentation and disclosure.
b. Existence or occurrence.
c. Rights and obligations.
d. Valuation or allocation.

M91#3. An auditor's purpose in reviewing the renewal of a note payable shortly after the balance sheet date most likely is to obtain evidence concerning management's assertions about
a. Existence or occurrence.
b. Presentation and disclosure.
c. Completeness.
d. Valuation or allocation.

M91#4. A basic premise underlying the application of analytical procedures is that
a. The study of financial ratios is an acceptable alternative to the investigation of unusual fluctuations.
b. Statistical tests of financial information may lead to the discovery of material errors in the financial statements.
c. Plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary.
d. These procedures **cannot** replace tests of balances and transactions.

M91#5. Which of the following comparisons would be most useful to an auditor in evaluating the results of an entity's operations?
a. Prior year accounts payable to current year accounts payable.
b. Prior year payroll expense to budgeted current year payroll expense.
c. Current year revenue to budgeted current year revenue.
d. Current year warranty expense to current year contingent liabilities.

M91#6. To which of the following matters would an auditor **not** apply materiality limits when obtaining specific written client representations?
a. Disclosure of compensating balance arrangements involving restrictions on cash balances.
b. Information concerning related party transactions and related amounts receivable or payable.
c. The absence of errors and unrecorded transactions in the financial statements.
d. Irregularities involving employees with significant roles in the internal control structure.

M91#7. Which of the following statements concerning the auditor's use of the work of a specialist is correct?
a. If the auditor believes that the determinations made by the specialist are unreasonable, only a qualified opinion may be issued.
b. If the specialist is related to the client, the auditor is still permitted to use the specialist's findings as corroborative evidence.
c. The specialist need **not** have an understanding of the auditor's corroborative use of the specialist's findings.
d. The specialist may be identified in the auditor's report when the auditor issues an unqualified opinion.

N90#16. The third standard of field work states that sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit. The substantive evidential matter required by this standard may be obtained, in part, through
a. Flowcharting the internal control structure.
b. Proper planning of the audit engagement.
c. Analytical procedures.
d. Auditor working papers.

N90#17. In testing the existence assertion for an asset, an auditor ordinarily works from the
a. Financial statements to the potentially unrecorded items.
b. Potentially unrecorded items to the financial statements.
c. Accounting records to the supporting evidence.
d. Supporting evidence to the accounting records.

N90#18. In an audit of inventories, an auditor would **least** likely verify that
a. All inventory owned by the client is on hand at the time of the count.
b. The client has used proper inventory pricing.
c. The financial statement presentation of inventories is appropriate.
d. Damaged goods and obsolete items have been properly accounted for.

N90#19. The scope of an audit is **not** restricted when an attorney's response to an auditor as a result of a client's letter of audit inquiry limits the response to
a. Matters to which the attorney has given substantive attention in the form of legal representation.
b. An evaluation of the likelihood of an unfavorable outcome of the matters disclosed by the entity.
c. The attorney's opinion of the entity's historical experience in recent similar litigation.
d. The probable outcome of asserted claims and pending or threatened litigation.

N90#20. Which of the following statements ordinarily is included among the written client representations obtained by the auditor?
a. Management acknowledges that there are **no** material weaknesses in the internal control structure.
b. Sufficient evidential matter has been made available to permit the issuance of an unqualified opinion.
c. Compensating balances and other arrangements involving restrictions on cash balances have been disclosed.
d. Management acknowledges responsibility for illegal actions committed by employees.

N90#21. Two assertions for which confirmation of accounts receivable balances provides primary evidence are

a. Completeness and valuation.
b. Valuation and rights and obligations.
c. Rights and obligations and existence.
d. Existence and completeness.

N90#22. For all audits of financial statements made in accordance with generally accepted auditing standards, the use of analytical procedures is required to some extent

	In the planning stage	*As a substantive test*	*In the review stage*
a.	Yes	No	Yes
b.	No	Yes	No
c.	No	Yes	Yes
d.	Yes	No	No

N90#23. Auditors try to identify predictable relationships when using analytical procedures. Relationships involving transactions from which of the following accounts most likely would yield the highest level of evidence?

a. Accounts payable.
b. Advertising expense.
c. Accounts receivable.
d. Payroll expense.

M90#1. As the acceptable level of detection risk decreases, an auditor may change the

a. Timing of substantive tests by performing them at an interim date rather than at year end.
b. Nature of substantive tests from a less effective to a more effective procedure.
c. Timing of tests of controls by performing them at several dates rather than at one time.
d. Assessed level of inherent risk to a higher amount.

M90#2. Which of the following factors would **least** influence an auditor's consideration of the reliability of data for purposes of analytical procedures?

a. Whether the data were processed in an EDP system or in a manual accounting system.
b. Whether sources within the entity were independent of those who are responsible for the amount being audited.
c. Whether the data were subjected to audit testing in the current or prior year.
d. Whether the data were obtained from independent sources outside the entity or from sources within the entity.

M90#5. An auditor testing long-term investments would ordinarily use analytical procedures to ascertain the reasonableness of the

a. Existence of unrealized gains or losses in the portfolio.
b. Completeness of recorded investment income.
c. Classification between current and noncurrent portfolios.
d. Valuation of marketable equity securities.

N89#27. Negative confirmation of accounts receivable is less effective than positive confirmation of accounts receivable because

a. A majority of recipients usually lack the willingness to respond objectively.
b. Some recipients may report incorrect balances that require extensive follow-up.
c. The auditor can **not** infer that all nonrespondents have verified their account information.
d. Negative confirmations do **not** produce evidential matter that is statistically quantifiable.

M89#1. Each of the following might, by itself, form a valid basis for an auditor to decide to omit a test **except** for the

a. Difficulty and expense involved in testing a particular item.
b. Degree of reliance on the relevant internal controls.
c. Relative risk involved.
d. Relationship between the cost of obtaining evidence and its usefulness.

M89#27. The primary objective of analytical procedures used in the final review stage of an audit is to

a. Obtain evidence from details tested to corroborate particular assertions.
b. Identify areas that represent specific risks relevant to the audit.
c. Assist the auditor in assessing the validity of the conclusions reached.
d. Satisfy doubts when questions arise about a client's ability to continue in existence.

M89#28. To help plan the nature, timing, and extent of substantive auditing procedures, preliminary analytical procedures should focus on

a. Enhancing the auditor's understanding of the client's business and events that have occurred since the last audit date.
b. Developing plausible relationships that corroborate anticipated results with a measurable amount of precision.
c. Applying ratio analysis to externally generated data such as published industry statistics or price indices.
d. Comparing recorded financial information to the results of other tests of transactions and balances.

M89#29. Cooper, CPA, is auditing the financial statements of a small rural municipality. The receivable balances represent residents' delinquent real estate taxes. The internal control structure at the municipality is weak. To determine the existence of the accounts receivable balances at the balance sheet date, Cooper would most likely

a. Send positive confirmation requests.
b. Send negative confirmation requests.
c. Examine evidence of subsequent cash receipts.
d. Inspect the internal records such as copies of the tax invoices that were mailed to the residents.

M89#30. An auditor would most likely verify the interest earned on bond investments by

a. Vouching the receipt and deposit of interest checks.
b. Confirming the bond interest rate with the issuer of the bonds.
c. Recomputing the interest earned on the basis of face amount, interest rate, and period held.
d. Testing the internal controls over cash receipts.

M89#34. A written client representation letter most likely would be an auditor's best source of corroborative information of a client's plans to

a. Terminate an employee pension plan.
b. Make a public offering of its common stock.
c. Settle an outstanding lawsuit for an amount less than the accrued loss contingency.
d. Discontinue a line of business.

N88#52. An auditor who uses the work of a specialist may refer to and identify the specialist in the auditor's report if the

a. Specialist is also considered to be a related party.
b. Auditor indicates a division of responsibility related to the work of the specialist.
c. Specialist's work provides the auditor greater assurance of reliability.
d. Auditor expresses an "except for" qualified opinion or an adverse opinion related to the work of the specialist.

N88#53. An auditor should obtain evidential matter relevant to all the following factors concerning third-party litigation against a client **except** the

a. Period in which the underlying cause for legal action occurred.
b. Probability of an unfavorable outcome.
c. Jurisdiction in which the matter will be resolved.
d. Existence of a situation indicating an uncertainty as to the possible loss.

M88#21. Which of the following statements is generally correct about the competence of evidential matter?

a. The auditor's direct personal knowledge, obtained through observation and inspection, is more persuasive than information obtained indirectly from independent outside sources.
b. To be competent, evidential matter must be either valid or relevant, but need **not** be both.
c. Accounting data alone may be considered sufficient competent evidential matter to issue an unqualified opinion on financial statements.
d. Competence of evidential matter refers to the amount of corroborative evidence to be obtained.

M88#22. To establish the existence and ownership of a long-term investment in the common stock of a publicly-traded company, an auditor ordinarily performs a security count or

a. Relies on the client's internal accounting controls if the auditor has reasonable assurance that the control procedures are being applied as prescribed.
b. Confirms the number of shares owned that are held by an independent custodian.
c. Determines the market price per share at the balance sheet date from published quotations.
d. Confirms the number of shares owned with the issuing company.

M88#24. An auditor testing long-term investments would ordinarily use analytical review as the primary audit procedure to ascertain the reasonableness of the

a. Valuation of marketable equity securities.
b. Classification of gains and losses on the disposal of securities.
c. Completeness of recorded investment income.
d. Existence and ownership of investments.

M88#46. "Provision has been made for any material loss that might be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices." The foregoing passage is most likely from

a. A management representation letter.
b. The explanatory paragraph of an "except for" qualified auditor's report.
c. A vendor representation letter.
d. The explanatory paragraph of a "subject to" qualified auditor's report.

B. Specific Audit Objectives and Procedures

M92#24. Which of the following statements ordinarily is correct concerning the content of working papers?

a. Whenever possible, the auditor's staff should prepare schedules and analyses rather than the entity's employees.
b. It is preferable to have negative figures indicated in red figures instead of parentheses to emphasize amounts being subtracted.
c. It is appropriate to use calculator tapes with names or explanations on the tapes rather than writing separate lists onto working papers.
d. The analysis of asset accounts and their related expense or income accounts should **not** appear on the same working paper.

M92#25. Which of the following most likely would be detected by an auditor's review of a client's sales cutoff?

a. Shipments lacking sales invoices and shipping documents.
b. Excessive write-offs of accounts receivable.
c. Unrecorded sales at year end.
d. Lapping of year-end accounts receivable.

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Items 26 and 27 are based on the following:

The information below was taken from the bank transfer schedule prepared during the audit of Fox Co.'s financial statements for the year ended December 31, 1991. Assume all checks are dated and issued on December 30, 1991.

	Bank Accounts		*Disbursement Date*		*Receipt Date*	
Check No.	*From*	*To*	*Per Books*	*Per Bank*	*Per Books*	*Per Bank*
101	National	Federal	Dec. 30	Jan. 4	Dec. 30	Jan. 3
202	County	State	Jan. 3	Jan. 2	Dec. 30	Dec. 31
303	Federal	American	Dec. 31	Jan. 3	Jan. 2	Jan. 2
404	State	Republic	Jan. 2	Jan. 2	Jan. 2	Dec. 31

26. Which of the following checks might indicate kiting?

a. #101 and #303.
b. #202 and #404.
c. #101 and #404.
d. #202 and #303.

27. Which of the following checks illustrate deposits/transfers in transit at December 31, 1991?

a. #101 and #202.
b. #101 and #303.
c. #202 and #404.
d. #303 and #404.

M92#28. Which of the following documentation is **not** required for an audit in accordance with generally accepted auditing standards?

a. A client engagement letter that summarizes the timing and details of the auditor's planned field work.
b. The basis for the auditor's conclusions when the assessed level of control risk is below the maximum level.
c. A written audit program setting forth the procedures necessary to accomplish the audit's objectives.
d. An indication that the accounting records agree or reconcile with the financial statements.

N91#49. If the objective of a test of details is to detect overstatements of sales, the auditor should trace transactions from the

a. Cash receipts journal to the sales journal.
b. Sales journal to the cash receipts journal.
c. Source documents to the accounting records.
d. Accounting records to the source documents.

N91#50. When searching for unrecorded liabilities at year end, an auditor most likely would examine

a. Cash receipts from related parties recorded before year end.
b. Confirmation requests returned by creditors whose accounts appear on a subsidiary trial balance of accounts payable.

c. Cash disbursements recorded in the period subsequent to year end.
d. Invoices dated a few days before and after year end to ascertain whether they have been properly recorded.

N91#51. Which of the following procedures most likely would justify the use of the negative form of accounts receivable confirmation?
a. A small number of accounts may be in dispute and the accounts receivable balance arises from sales to a few major customers.
b. A small number of accounts may be in dispute and the accounts receivable balance arises from sales to many customers with small balances.
c. A substantial number of accounts may be in dispute and the accounts receivable balance arises from sales to a few major customers.
d. A substantial number of accounts may be in dispute and the accounts receivable balance arises from sales to many customers with small balances.

N91#52. The audit working paper that reflects the major components of an amount reported in the financial statements is the
a. Interbank transfer schedule.
b. Carryforward schedule.
c. Supporting schedule.
d. Lead schedule.

N91#53. Which of the following is required documentation in an audit in accordance with generally accepted auditing standards?
a. A written engagement letter formalizing the level of service to be rendered.
b. A flowchart depicting the segregation of duties and authorization of transactions.
c. A written audit program describing the necessary procedures to be performed.
d. A memorandum setting forth the scope of the audit.

N91#54. An auditor should trace bank transfers for the last part of the audit period and first part of the subsequent period to detect whether
a. The cash receipts journal was held open for a few days after the year end.
b. The last checks recorded before the year end were actually mailed by the year end.
c. Cash balances were overstated because of kiting.
d. Any unusual payments to or receipts from related parties occurred.

M91#8. An auditor's program to examine long-term debt most likely would include steps that require
a. Comparing the carrying amount of the debt to its year-end market value.
b. Correlating interest expense recorded for the period with outstanding debt.
c. Verifying the existence of the holders of the debt by direct confirmation.
d. Inspecting the accounts payable subsidiary ledger for unrecorded long-term debt.

M91#9. The negative request form of accounts receivable confirmation is useful particularly when the

	Assessed level of control risk relating to receivables is	*Number of small balances is*	*Consideration by the recipient is*
a.	Low	Many	Likely
b.	Low	Few	Unlikely
c.	High	Few	Likely
d.	High	Many	Likely

M91#10. Which of the following audit procedures is best for identifying unrecorded trade accounts payable?
a. Examining unusual relationships between monthly accounts payable balances and recorded cash payments.
b. Reconciling vendors' statements to the file of receiving reports to identify items received just prior to the balance sheet date.
c. Reviewing cash disbursements recorded subsequent to the balance sheet date to determine whether the related payables apply to the prior period.
d. Investigating payables recorded just prior to and just subsequent to the balance sheet date to determine whether they are supported by receiving reports.

M91#11. A client maintains perpetual inventory records in both quantities and dollars. If the assessed level of control risk is high, an auditor would probably
a. Insist that the client perform physical counts of inventory items several times during the year.
b. Apply gross profit tests to ascertain the reasonableness of the physical counts.
c. Increase the extent of tests of controls of the inventory cycle.
d. Request the client to schedule the physical inventory count at the end of the year.

M91#12. An auditor ordinarily uses a working trial balance resembling the financial statements without footnotes, but containing columns for

a. Reclassifications and adjustments.
b. Reconciliations and tickmarks.
c. Accruals and deferrals.
d. Expense and revenue summaries.

M91#13. The current file of an auditor's working papers most likely would include a copy of the

a. Bank reconciliation.
b. Pension plan contract.
c. Articles of incorporation.
d. Flowchart of the internal control procedures.

N90#24. Which of the following procedures is **least** likely to be performed before the balance sheet date?

a. Testing of internal control over cash.
b. Confirmation of receivables.
c. Search for unrecorded liabilities.
d. Observation of inventory.

N90#26. When auditing prepaid insurance, an auditor discovers that the original insurance policy on plant equipment is not available for inspection. The policy's absence most likely indicates the possibility of a(an)

a. Insurance premium due but **not** recorded.
b. Deficiency in the coinsurance provision.
c. Lien on the plant equipment.
d. Understatement of insurance expense.

M90#6. An auditor would be most likely to identify a contingent liability by obtaining a(an)

a. Accounts payable confirmation.
b. Transfer agent confirmation.
c. Standard bank confirmation.
d. Related party transaction confirmation.

M90#7. An auditor's working papers should

a. Not be permitted to serve as a reference source for the client.
b. Not contain critical comments concerning management.
c. Show that the accounting records agree or reconcile with the financial statements.
d. Be considered the primary support for the financial statements being audited.

M90#10. When a client company does **not** maintain its own stock records, the auditor should obtain written confirmation from the transfer agent and registrar concerning

a. Restrictions on the payment of dividends.
b. The number of shares issued and outstanding.
c. Guarantees of preferred stock liquidation value.
d. The number of shares subject to agreements to repurchase.

N89#28. An auditor's program to examine long-term debt should include steps that require

a. Examining bond trust indentures.
b. Inspecting the accounts payable subsidiary ledger.
c. Investigating credits to the bond interest income account.
d. Verifying the existence of the bondholders.

N89#29. Which of the following audit procedures would most likely assist an auditor in identifying conditions and events that may indicate there could be substantial doubt about an entity's ability to continue as a going concern?

a. Review compliance with the terms of debt agreements.
b. Confirmation of accounts receivable from principal customers.
c. Reconciliation of interest expense with debt outstanding.
d. Confirmation of bank balances.

N89#30. Which of the following documentation is required for an audit in accordance with generally accepted auditing standards?

a. An internal control questionnaire.
b. A client engagement letter.
c. A planning memorandum or checklist.
d. A client representation letter.

M89#33. Tracing selected items from the payroll register to employee time cards that have been approved by supervisory personnel provides evidence that

a. Internal controls relating to payroll disbursements were operating effectively.
b. Payroll checks were signed by an appropriate officer independent of the payroll preparation process.
c. Only bona fide employees worked and their pay was properly computed.
d. Employees worked the number of hours for which their pay was computed.

M89#35. In an audit of contingent liabilities, which of the following procedures would be **least** effective?

a. Reviewing a bank confirmation letter.
b. Examining customer confirmation replies.
c. Examining invoices for professional services.
d. Reading the minutes of the board of directors.

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Items 36 and 37 are based on the following:

Miles Company
Bank Transfer Schedule
December 31, 1988

Check Number	*Bank Accounts*			*Date disbursed per*		*Date deposited per*	
	From	*To*	*Amount*	*Books*	*Bank*	*Books*	*Bank*
2020	1st Natl.	Suburban	$32,000	12/31	1/5 ◆	12/31	1/3 ▲
2021	1st Natl.	Capital	21,000	12/31	1/4 ◆	12/31	1/3 ▲
3217	2nd State	Suburban	6,700	1/3	1/5	1/3	1/6
0659	Midtown	Suburban	5,500	12/30	1/5 ◆	12/30	1/3 ▲

36. The tick mark ◆ most likely indicates that the amount was traced to the
    a. December cash disbursements journal.
    b. Outstanding checklist of the applicable bank reconciliation.
    c. January cash disbursements journal.
    d. Year-end bank confirmations.

37. The tick mark ▲ most likely indicates that the amount was traced to the
    a. Deposits in transit of the applicable bank reconciliation.
    b. December cash receipts journal.
    c. January cash receipts journal.
    d. Year-end bank confirmations.

N88#54. An auditor analyzes repairs and maintenance accounts primarily to obtain evidence in support of the audit assertion that all
    a. Noncapitalizable expenditures for repairs and maintenance have been properly charged to expense.
    b. Expenditures for property and equipment have **not** been charged to expense.
    c. Noncapitalizable expenditures for repairs and maintenance have been recorded in the proper period.
    d. Expenditures for property and equipment have been recorded in the proper period.

N88#55. For which of the following account balances are substantive tests of details **least** likely to be performed unless analytical review procedures indicate the need to extend detail testing?
    a. Payroll expense.
    b. Marketable securities.
    c. Research and development costs.
    d. Legal expense.

N88#56. Which of the following statements concerning working papers is incorrect?
    a. An auditor may support an opinion by other means in addition to working papers.
    b. The form of working papers should be designed to meet the circumstances of a particular engagement.
    c. An auditor's working papers may **not** serve as a reference source for the client.
    d. Working papers should show that the internal accounting control system has been studied and evaluated to the degree necessary.

M88#26. Which of the following cash transfers results in a misstatement of cash at December 31, 1987?

Bank Transfer Schedule

	Disbursement		*Receipt*	
Transfer	*Recorded in books*	*Paid by bank*	*Recorded in books*	*Received by bank*
a.	12/31/87	1/4/88	12/31/87	12/31/87
b.	1/4/88	1/5/88	12/31/87	1/4/88
c.	12/31/87	1/5/88	12/31/87	1/4/88
d.	1/4/88	1/11/88	1/4/88	1/4/88

M88#27. An auditor should trace corporate stock issuances and treasury stock transactions to the
    a. Numbered stock certificates.
    b. Articles of incorporation.
    c. Transfer agent's records.
    d. Minutes of the board of directors.

M88#28. Which of the following procedures would an auditor most likely rely on to verify management's assertion of completeness?
    a. Review standard bank confirmations for indications of kiting.
    b. Compare a sample of shipping documents to related sales invoices.
    c. Observe the client's distribution of payroll checks.
    d. Confirm a sample of recorded receivables by direct communication with the debtors.

M88#29. Working papers ordinarily would **not** include
    a. Initials of the in-charge auditor indicating review of the staff assistants' work.
    b. Cut-off bank statements received directly from the banks.

c. A memo describing the preliminary review of the internal accounting control system.
d. Copies of client inventory count sheets.

M88#39. The current file of the auditor's working papers generally should include
a. A flowchart of the internal accounting controls.
b. Organization charts.
c. A copy of the financial statements.
d. Copies of bond and note indentures.

C. Other Specific Audit Topics

M92#29. Which of the following sampling methods would be used to estimate a numerical measurement of a population, such as a dollar value?
a. Discovery sampling.
b. Numerical sampling.
c. Sampling for attributes.
d. Sampling for variables.

M92#30. In a probability-proportional-to-size sample with a sampling interval of $5,000, an auditor discovered that a selected account receivable with a recorded amount of $10,000 had an audit amount of $8,000. If this were the only error discovered by the auditor, the projected error of this sample would be
a. $1,000
b. $2,000
c. $4,000
d. $5,000

M92#31. When auditing related party transactions, an auditor places primary emphasis on
a. Confirming the existence of the related parties.
b. Verifying the valuation of the related party transactions.
c. Evaluating the disclosure of the related party transactions.
d. Ascertaining the rights and obligations of the related parties.

M92#32. In an audit in accordance with *Government Auditing Standards* an auditor is required to report on the auditor's tests of the entity's compliance with applicable laws and regulations. This requirement is satisfied by designing the audit to provide
a. Positive assurance that the internal control policies and procedures tested by the auditor are operating as prescribed.
b. Reasonable assurance of detecting misstatements that are material to the financial statements.
c. Negative assurance that reportable conditions communicated during the audit do **not** prevent the auditor from expressing an opinion.
d. Limited assurance that the internal control structure designed by management will prevent or detect errors, irregularities, and illegal acts.

M92#33. An auditor concludes that a substantive auditing procedure considered necessary during the prior period's audit was omitted. Which of the following factors would most likely cause the auditor promptly to apply the omitted procedure?
a. There are **no** alternative procedures available to provide the same evidence as the omitted procedure.
b. The omission of the procedure impairs the auditor's present ability to support the previously expressed opinion.
c. The source documents needed to perform the omitted procedure are still available.
d. The auditor's opinion on the prior period's financial statements was unqualified.

N91#24. Which of the following is **not** a major reason for maintaining an audit trail for a computer system?
a. Deterrent to irregularities.
b. Monitoring purposes.
c. Analytical procedures.
d. Query answering.

N91#55. To obtain evidence that user identification and password controls are functioning as designed, an auditor would most likely
a. Review the online transaction log to ascertain whether employees using passwords have access to data files and computer programs.
b. Examine a sample of assigned passwords and access authority to determine whether password holders have access authority incompatible with their other responsibilities.
c. Extract a random sample of processed transactions and ensure that transactions are appropriately authorized.
d. Observe the file librarian's activities to discover whether other systems personnel are permitted to operate computer equipment without restriction.

N91#56. After identifying related party transactions, an auditor most likely would
a. Substantiate that the transactions were consummated on terms equivalent to those prevailing in arms-length transactions.
b. Discuss the implications of the transactions with third parties, such as the entity's attorneys and bankers.
c. Determine whether the transactions were approved by the board of directors or other appropriate officials.
d. Ascertain whether the transactions would have occurred if the parties had **not** been related.

N91#57. An auditor issued an audit report that was dual dated for a subsequent event occurring after the completion of field work but before issuance of the auditor's report. The auditor's responsibility for events occurring subsequent to the completion of field work was

a. Extended to subsequent events occurring through the date of issuance of the report.
b. Extended to include all events occurring since the completion of field work.
c. Limited to the specific event referenced.
d. Limited to include only events occurring up to the date of the last subsequent event referenced.

M91#14. An auditor would **least** likely use computer software to

a. Access client data files.
b. Prepare spreadsheets.
c. Assess EDP control risk.
d. Construct parallel simulations.

M91#15. An auditor using audit software probably would be **least** interested in which of the following fields in a computerized perpetual inventory file?

a. Economic order quantity.
b. Warehouse location.
c. Date of last purchase.
d. Quantity sold.

M91#16. An auditor would most likely be concerned with which of the following controls in a distributed data processing system?

a. Hardware controls.
b. Systems documentation controls.
c. Access controls.
d. Disaster recovery controls.

M91#17. Which of the following statements is correct concerning probability proportional to size (PPS) sampling, also known as dollar unit sampling?

a. The sampling distribution should approximate the normal distribution.
b. Overstated units have a lower probability of sample selection than units that are understated.
c. The auditor controls the risk of incorrect acceptance by specifying that risk level for the sampling plan.
d. The sampling interval is calculated by dividing the number of physical units in the population by the sample size.

M91#18. When using classical variables sampling for estimation, an auditor normally evaluates the sampling results by calculating the possible error in either direction. This statistical concept is known as

a. Precision.
b. Reliability.
c. Projected error.
d. Standard deviation.

N90#28. When an auditor tests a computerized accounting system, which of the following is true of the test data approach?

a. Test data must consist of all possible valid and invalid conditions.
b. The program tested is different from the program used throughout the year by the client.
c. Several transactions of each type must be tested.
d. Test data are processed by the client's computer programs under the auditor's control.

N90#29. A primary advantage of using generalized audit software packages to audit the financial statements of a client that uses an EDP system is that the auditor may

a. Consider increasing the use of substantive tests of transactions in place of analytical procedures.
b. Substantiate the accuracy of data through self-checking digits and hash totals.
c. Reduce the level of required tests of controls to a relatively small amount.
d. Access information stored on computer files while having a limited understanding of the client's hardware and software features.

N90#30. Stratified mean per unit (MPU) sampling is a statistical technique that may be more efficient than unstratified MPU because it usually

a. May be applied to populations where many monetary errors are expected to occur.
b. Produces an estimate having a desired level of precision with a smaller sample size.
c. Increases the variability among items in a stratum by grouping sampling units with similar characteristics.
d. Yields a weighted sum of the strata standard deviations that is greater than the standard deviation of the population.

N90#31. An advantage of statistical sampling over nonstatistical sampling is that statistical sampling helps an auditor to

a. Eliminate the risk of nonsampling errors.
b. Reduce the level of audit risk and materiality to a relatively low amount.
c. Measure the sufficiency of the evidential matter obtained.
d. Minimize the failure to detect errors and irregularities.

N90#32. Which of the following events most likely indicates the existence of related parties?

a. Borrowing a large sum of money at a variable rate of interest.
b. Selling real estate at a price that differs significantly from its book value.
c. Making a loan without scheduled terms for repayment of the funds.
d. Discussing merger terms with a company that is a major competitor.

N90#33. Which of the following procedures would an auditor ordinarily perform during the review of subsequent events?

a. Review the cut-off bank statements for the period after the year-end.
b. Inquire of the client's legal counsel concerning litigation.
c. Investigate reportable conditions previously communicated to the client.
d. Analyze related party transactions to discover possible irregularities.

N90#34. Because of the pervasive effects of laws and regulations on the financial statements of governmental units, an auditor should obtain written management representations acknowledging that management has

a. Implemented internal control policies and procedures designed to detect all illegal acts.
b. Documented the procedures performed to evaluate the governmental unit's compliance with laws and regulations.
c. Identified and disclosed all laws and regulations that have a direct and material effect on its financial statements.
d. Reported all known illegal acts and material weaknesses in internal control structure to the funding agency or regulatory body.

N90#35. Six months after issuing an unqualified opinion on audited financial statements, an auditor discovered that the engagement personnel failed to confirm several of the client's material accounts receivable balances. The auditor should first

a. Request the permission of the client to undertake the confirmation of accounts receivable.
b. Perform alternative procedures to provide a satisfactory basis for the unqualified opinion.
c. Assess the importance of the omitted procedures to the auditor's ability to support the previously expressed opinion.
d. Inquire whether there are persons currently relying, or likely to rely, on the unqualified opinion.

M90#8. Processing data through the use of simulated files provides an auditor with information about the operating effectiveness of control policies and procedures. One of the techniques involved in this approach makes use of

a. Input validation.
b. Program code checking.
c. Controlled reprocessing.
d. Integrated test facility.

M90#9. An auditor would be most likely to consider modifying an otherwise unqualified opinion if the client's financial statements include a footnote on related party transactions

a. Representing that certain related party transactions were consummated on terms equivalent to those obtainable in transactions with unrelated parties.
b. Presenting the dollar volume of related party transactions and the effects of any change in the method of establishing terms from that used in the prior period.
c. Explaining the business purpose of the sale of real property to a related party.
d. Disclosing compensating balance arrangements maintained for the benefit of related parties.

N89#31. When an accounting application is processed by computer, an auditor can **not** verify the reliable operation of programmed control procedures by

a. Manually comparing detail transaction files used by an edit program to the program's generated error listings to determine that errors were properly identified by the edit program.
b. Constructing a processing system for accounting applications and processing actual data from throughout the period through both the client's program and the auditor's program.
c. Manually reperforming, as of a point in time, the processing of input data and comparing the simulated results to the actual results.
d. Periodically submitting auditor-prepared test data to the same computer process and evaluating the results.

N89#32. To obtain evidence that user identification and password controls are functioning as designed, an auditor would most likely

a. Attempt to sign-on to the system using invalid user identifications and passwords.
b. Write a computer program that simulates the logic of the client's access control software.
c. Extract a random sample of processed transactions and ensure that the transactions were appropriately authorized.
d. Examine statements signed by employees stating that they have **not** divulged their user identifications and passwords to any other person.

N89#33. While performing a substantive test of details during an audit, the auditor determined that the sample results supported the conclusion that the recorded account balance was materially misstated. It was, in fact, not materially misstated. This situation illustrates the risk of

a. Incorrect rejection.
b. Incorrect acceptance.
c. Overreliance.
d. Underreliance.

M89#39. Which of the following computer-assisted auditing techniques allows fictitious and real transactions to be processed together without client operating personnel being aware of the testing process?

a. Parallel simulation.
b. Generalized audit software programming.
c. Integrated test facility.
d. Test data approach.

M89#40. In a probability-proportional-to-size sample with a sampling interval of $10,000, an auditor discovered that a selected account receivable with a recorded amount of $5,000 had an audit amount of $2,000. The projected error of this sample was

a. $3,000.
b. $4,000.
c. $6,000.
d. $8,000.

M89#41. An auditor is performing substantive tests of pricing and extensions of perpetual inventory balances consisting of a large number of items. Past experience indicates numerous pricing and extension errors. Which of the following statistical sampling approaches is most appropriate?

a. Unstratified mean-per-unit.
b. Probability-proportional-to-size.
c. Stop or go.
d. Ratio estimation.

M89#42. An auditor searching for related party transactions should obtain an understanding of each subsidiary's relationship to the total entity because

a. This may permit the audit of intercompany account balances to be performed as of concurrent dates.
b. Intercompany transactions may have been consummated on terms equivalent to arm's-length transactions.
c. This may reveal whether particular transactions would have taken place if the parties had **not** been related.
d. The business structure may be deliberately designed to obscure related party transactions.

M89#43. A typical objective of an operational audit is to determine whether an entity's

a. Internal control structure is adequately operating as designed.
b. Operational information is in accordance with generally accepted governmental auditing standards.
c. Financial statements present fairly the results of operations.
d. Specific operating units are functioning efficiently and effectively.

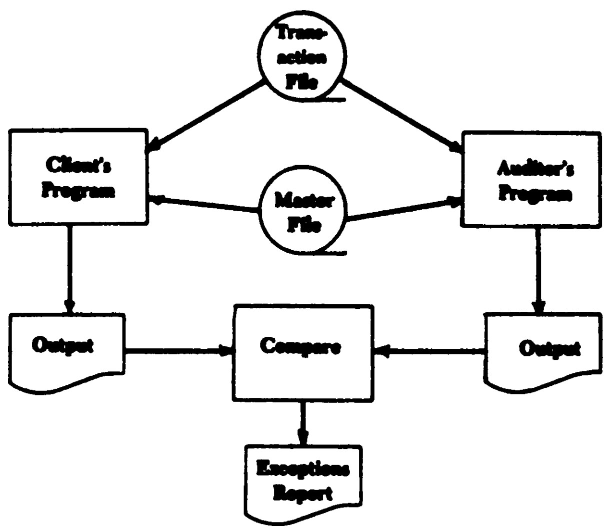
M89#44. An auditor concludes that the omission of a substantive procedure considered necessary at the time of the examination may impair the auditor's present ability to support the previously expressed opinion. The auditor need **not** apply the omitted procedure if

a. The risk of adverse publicity or litigation is low.
b. The results of other procedures that were applied tend to compensate for the procedure omitted.
c. The auditor's opinion was qualified because of a departure from generally accepted accounting principles.
d. The results of the subsequent period's tests of controls make the omitted procedure less important.

N88#57. The two requirements crucial to achieving audit efficiency and effectiveness with a microcomputer are selecting

a. The appropriate audit tasks for microcomputer applications and the appropriate software to perform the selected audit tasks.
b. The appropriate software to perform the selected audit tasks and client data that can be accessed by the auditor's microcomputer.
c. Client data that can be accessed by the auditor's microcomputer and audit procedures that are generally applicable to several clients in a specific industry.
d. Audit procedures that are generally applicable to several clients in a specific industry and the appropriate audit tasks for microcomputer applications.

N88
Item 59 is based on the following flowchart:



59. The above flowchart depicts
   a. Program code checking.
   b. Parallel simulation.
   c. Integrated test facility.
   d. Controlled reprocessing.

M88#17. Using microcomputers in auditing may affect the methods used to review the work of staff assistants because

a. Supervisory personnel may **not** have an understanding of the capabilities and limitations of microcomputers.
b. Working paper documentation may **not** contain readily observable details of calculations.

c. The audit field work standards for supervision may differ.
d. Documenting the supervisory review may require assistance of management services personnel.

M88#33. A number of factors influences the sample size for a substantive test of details of an account balance. All other factors being equal, which of the following would lead to a larger sample size?

a. Greater reliance on internal accounting controls.
b. Greater reliance on analytical review procedures.
c. Smaller expected frequency of errors.
d. Smaller measure of tolerable error.

M88#34. Which of the following statements is correct concerning the auditor's use of statistical sampling?

a. An auditor needs to estimate the dollar amount of the standard deviation of the population to use classical variables sampling.
b. An assumption of PPS sampling is that the underlying accounting population is normally distributed.
c. A classical variables sample needs to be designed with special considerations to include negative balances in the sample.
d. The selection of zero balances usually does **not** require special sample design considerations when using PPS sampling.

M88#35. Which of the following statements is correct concerning related party transactions?

a. In the absence of evidence to the contrary, related party transactions should be assumed to be outside the ordinary course of business.
b. An auditor should determine whether a particular transaction would have occurred if the parties had **not** been related.
c. An auditor should substantiate that related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions.
d. The audit procedures directed toward identifying related party transactions should include considering whether transactions are occurring, but are **not** being given proper accounting recognition.

M88#36. Ajax Company's auditor concludes that the omission of an audit procedure considered necessary at the time of the prior examination impairs the auditor's present ability to support the previously expressed unqualified opinion. If the auditor believes there are stockholders currently relying on the opinion, the auditor should promptly

a. Notify the stockholders currently relying on the previously expressed unqualified opinion that they should **not** rely on it.
b. Advise management to disclose this development in its next interim report to the stockholders.
c. Advise management to revise the financial statements with full disclosure of the auditor's inability to support the unqualified opinion.
d. Undertake to apply the omitted procedure or alternate procedures that would provide a satisfactory basis for the opinion.

M88#37. A governmental audit may extend beyond an examination leading to the expression of an opinion on the fairness of financial presentation to include

	Program results	*Compliance*	*Economy & efficiency*
a.	Yes	Yes	No
b.	Yes	Yes	Yes
c.	No	Yes	Yes
d.	Yes	No	Yes

M88#38. Which of the following procedures would an auditor most likely perform to obtain evidence about an entity's subsequent events?

a. Reconcile bank activity for the month after the balance sheet date with cash activity reflected in the accounting records.
b. Examine on a test basis the purchase invoices and receiving reports for several days after the inventory date.
c. Review the treasurer's monthly reports on temporary investments owned, purchased, and sold.
d. Obtain a letter from the entity's attorney describing any pending litigation, unasserted claims, or loss contingencies.

D. Review and Compilation Procedures

M92#34. Which of the following procedures is usually performed by the accountant in a review engagement of a nonpublic entity?

a. Sending a letter of inquiry to the entity's lawyer.
b. Comparing the financial statements with statements for comparable prior periods.
c. Confirming a significant percentage of receivables by direct communication with debtors.
d. Communicating reportable conditions discovered during the study of the internal control structure.

M92#35. Which of the following procedures is more likely to be performed in a review engagement of a nonpublic entity than in a compilation engagement?

a. Gaining an understanding of the entity's business transactions.
b. Making a preliminary assessment of control risk.
c. Obtaining a representation letter from the chief executive officer.
d. Assisting the entity in adjusting the accounting records.

N91#58. When providing limited assurance that the financial statements of a nonpublic entity require **no** material modifications to be in accordance with generally accepted accounting principles, the accountant should

a. Understand the accounting principles of the industry in which the entity operates.
b. Develop audit programs to determine whether the entity's financial statements are fairly presented.
c. Assess the risk that a material misstatement could occur in a financial statement assertion.
d. Confirm with the entity's lawyer that material loss contingencies are disclosed.

N91#59. Which of the following statements is correct concerning both an engagement to compile and an engagement to review a nonpublic entity's financial statements?

a. The accountant does **not** contemplate obtaining an understanding of the internal control structure.
b. The accountant must be independent in fact and appearance.
c. The accountant expresses **no** assurance on the financial statements.
d. The accountant should obtain a written management representation letter.

M91#19. When compiling a nonpublic entity's financial statements, an accountant would be **least** likely to

a. Perform analytical procedures designed to identify relationships that appear to be unusual.
b. Read the compiled financial statements and consider whether they appear to include adequate disclosure.
c. Omit substantially all of the disclosures required by generally accepted accounting principles.
d. Issue a compilation report on one or more, but **not** all, of the basic financial statements.

M91#20. Which of the following procedures would most likely be included in a review engagement of a nonpublic entity?

a. Preparing a bank transfer schedule.
b. Inquiring about related party transactions.
c. Assessing the internal control structure.
d. Performing cutoff tests on sales and purchases transactions.

M90#4. Inquiry and analytical procedures ordinarily performed during a review of a nonpublic entity's financial statements include

a. Inquiries concerning actions taken at meetings of the stockholders and the board of directors.
b. Analytical procedures designed to test the accounting records by obtaining corroborating evidential matter.
c. Inquiries designed to identify reportable conditions in the internal control structure.
d. Analytical procedures concerning management's assertions regarding continued existence.

N89#35. Before performing a review of a nonpublic entity's financial statements, an accountant should

a. Complete a series of inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions.
b. Apply analytical procedures to provide limited assurance that **no** material modifications should be made to the financial statements.
c. Obtain a sufficient level of knowledge of the accounting principles and practices of the industry in which the entity operates.
d. Inquire whether management has omitted substantially all of the disclosures required by generally accepted accounting principles.

M89#45. One of the conditions required for an accountant to submit a written personal financial plan containing unaudited financial statements to a client without complying with the requirements of SSARS 1 (Compilation and Review of Financial Statements) is that the

a. Client agrees that the financial statements will **not** be used to obtain credit.
b. Accountant compiled or reviewed the client's financial statements for the immediate prior year.
c. Engagement letter acknowledges that the financial statements will contain departures from generally accepted accounting principles.
d. Accountant expresses limited assurance that the financial statements are free of any material misstatements.

M88#40. Which of the following procedures is **not** usually performed by the accountant in a review engagement of a nonpublic entity?

a. Communicating any material weaknesses discovered during the study and evaluation of internal accounting control.
b. Reading the financial statements to consider whether they conform with generally accepted accounting principles.
c. Writing an engagement letter to establish an understanding regarding the services to be performed.
d. Issuing a report stating that the review was performed in accordance with standards established by the AICPA.

IV. Reporting

A. Reporting Standards and Types of Reports

M92#1. When engaged to audit a governmental entity in accordance with *Government Auditing Standards,* an auditor prepares a written report on the internal control structure

a. In all audits, regardless of circumstances.
b. Only when the auditor has noted reportable conditions.
c. Only when requested by the governmental entity being audited.
d. Only when requested by the federal government funding agency.

M92#2. When an independent CPA assists in preparing the financial statements of a publicly held entity, but has **not** audited or reviewed them, the CPA should issue a disclaimer of opinion. In such situations, the CPA has **no** responsibility to apply any procedures beyond

a. Ascertaining whether the financial statements are in conformity with generally accepted accounting principles.
b. Determining whether management has elected to omit substantially all required disclosures.
c. Documenting that the internal control structure is **not** being relied on.
d. Reading the financial statements for obvious material misstatements.

M92#3. When a predecessor auditor reissues the report on the prior period's financial statements at the request of the former client, the predecessor auditor should

a. Indicate in the introductory paragraph of the reissued report that the financial statements of the subsequent period were audited by another CPA.
b. Obtain an updated management representation letter and compare it to that obtained during the prior period audit.
c. Compare the prior period's financial statements that the predecessor reported on with the financial statements to be presented for comparative purposes.
d. Add an explanatory paragraph to the reissued report stating that the predecessor has **not** performed additional auditing procedures concerning the prior period's financial statements.

M92#4. Clark, CPA, compiled and properly reported on the financial statements of Green Co., a nonpublic entity, for the year ended March 31, 1991. These financial statements omitted substantially all disclosures required by generally accepted accounting principles (GAAP). Green asked Clark to compile the statements for the year ended March 31, 1992, and to include all GAAP disclosures for the 1992 statements only, but otherwise present both years' financial statements in comparative form. What is Clark's responsibility concerning the proposed engagement?

a. Clark may **not** report on the comparative financial statements because the 1991 statements are **not** comparable to the 1992 statements that include the GAAP disclosures.
b. Clark may report on the comparative financial statements provided the 1991 statements do **not** contain any obvious material misstatements.
c. Clark may report on the comparative financial statements provided an explanatory paragraph is added to Clark's report on the comparative financial statements.
d. Clark may report on the comparative financial statements provided Clark updates the report on the 1991 statements that do **not** include the GAAP disclosures.

M92#5. Which of the following statements should **not** be included in an accountant's standard report based on the compilation of an entity's financial statements?

a. A statement that the compilation was performed in accordance with standards established by the American Institute of CPAs.
b. A statement that the accountant has **not** audited or reviewed the financial statements.
c. A statement that the accountant does **not** express an opinion but expresses only limited assurance on the financial statements.
d. A statement that a compilation is limited to presenting, in the form of financial statements, information that is the representation of management.

M92#6. An accountant who had begun an audit of the financial statements of a nonpublic entity was asked to change the engagement to a review because of a restriction on the scope of the audit. If there is reasonable justification for the change, the accountant's review report should include reference to the

	Original engagement that was agreed to	*Scope limitation that caused the changed engagement*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M92#7. When reporting on financial statements prepared on the same basis of accounting used for income tax purposes, the auditor should include in the report a paragraph that

a. States that the income tax basis of accounting is a comprehensive basis of accounting other than generally accepted accounting principles.
b. Justifies the use of the income tax basis of accounting.
c. Emphasizes that the financial statements are **not** intended to have been audited in accordance with generally accepted auditing standards.
d. Refers to the authoritative pronouncements that explain the income tax basis of accounting being used.

M92#8. When an accountant issues to an underwriter a comfort letter containing comments on data that have **not** been audited, the underwriter most likely will receive

a. Negative assurance on capsule information.
b. Positive assurance on supplementary disclosures.
c. A limited opinion on "pro forma" financial statements.
d. A disclaimer on prospective financial statements.

M92#9. An accountant's compilation report on a financial forecast should include a statement that the

a. Compilation does **not** include evaluation of the support of the assumptions underlying the forecast.
b. Hypothetical assumptions used in the forecast are reasonable.
c. Range of assumptions selected is one in which one end of the range is less likely to occur than the other.
d. Prospective statements are limited to presenting, in the form of a forecast, information that is the accountant's representation.

M92#10. When engaged to audit a not-for-profit organization in accordance with *Government Auditing Standards,* an auditor is required to prepare a written report on compliance with laws and regulations that includes

a. All material and immaterial instances of noncompliance with laws and regulations.
b. All instances or indications of illegal acts that could result in criminal prosecution.
c. A description of all material weaknesses noted during the engagement.
d. An explanation of the inherent limitations of the internal control structure.

M92#11. An auditor's responsibility to express an opinion on the financial statements is

a. Implicitly represented in the auditor's standard report.
b. Explicitly represented in the opening paragraph of the auditor's standard report.
c. Explicitly represented in the scope paragraph of the auditor's standard report.
d. Explicitly represented in the opinion paragraph of the auditor's standard report.

N91#16. An auditor may reasonably issue an "except for" qualified opinion for a(an)

	Scope limitation	*Unjustified accounting change*
a.	Yes	No
b.	No	Yes
c.	Yes	Yes
d.	No	No

N91#17. Helpful Co., a nonprofit entity, prepared its financial statements on an accounting basis prescribed by a regulatory agency solely for filing with that agency. Green audited the financial statements in accordance with generally accepted auditing standards and concluded that the financial statements were fairly presented on the prescribed basis. Green should issue a

a. Qualified opinion.
b. Standard three paragraph report with reference to footnote disclosure.
c. Disclaimer of opinion.
d. Special report.

N91#18. The following explanatory paragraph was included in an auditor's report to indicate a lack of consistency:

> "As discussed in note T to the financial statements, the company changed its method of computing depreciation in 1990."

How should the auditor report on this matter if the auditor concurred with the change?

	Type of opinion	*Location of explanatory paragraph*
a.	Unqualified	Before opinion paragraph
b.	Unqualified	After opinion paragraph
c.	Qualified	Before opinion paragraph
d.	Qualified	After opinion paragraph

N91#19. When an auditor concludes there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, the auditor's responsibility is to

a. Prepare prospective financial information to verify whether management's plans can be effectively implemented.

b. Project future conditions and events for a period of time **not** to exceed one year following the date of the financial statements.
c. Issue a qualified or adverse opinion, depending upon materiality, due to the possible effects on the financial statements.
d. Consider the adequacy of disclosure about the entity's possible inability to continue as a going concern.

N91#21. How does an auditor make the following representations when issuing the standard auditor's report on comparative financial statements?

	Examination of evidence on a test basis	*Consistent application of accounting principles*
a.	Explicitly	Explicitly
b.	Implicitly	Implicitly
c.	Implicitly	Explicitly
d.	Explicitly	Implicitly

N91#22. An auditor was unable to obtain sufficient competent evidential matter concerning certain transactions due to an inadequacy in the entity's accounting records. The auditor would choose between issuing a(an)

a. Qualified opinion and an unqualified opinion with an explanatory paragraph.
b. Unqualified opinion with an explanatory paragraph and an adverse opinion.
c. Adverse opinion and a disclaimer of opinion.
d. Disclaimer of opinion and a qualified opinion.

N91#23. For an entity's financial statements to be presented fairly in conformity with generally accepted accounting principles, the principles selected should

a. Be applied on a basis consistent with those followed in the prior year.
b. Be approved by the Auditing Standards Board or the appropriate industry subcommittee.
c. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
d. Match the principles used by most other entities within the entity's particular industry.

N91#25. Financial statements of a nonpublic entity that have been reviewed by an accountant should be accompanied by a report stating that

a. The scope of the inquiry and analytical procedures performed by the accountant has **not** been restricted.
b. All information included in the financial statements is the representation of the management of the entity.
c. A review includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
d. A review is greater in scope than a compilation, the objective of which is to present financial statements that are free of material misstatements.

N91#26. How does an accountant make the following representations when issuing the standard report for the compilation of a nonpublic entity's financial statements?

	The financial statements have not been audited	*The accountant has compiled the financial statements*
a.	Implicitly	Implicitly
b.	Explicitly	Explicitly
c.	Implicitly	Explicitly
d.	Explicitly	Implicitly

N91#27. The objective of a review of interim financial information of a public entity is to provide the accountant with a basis for

a. Determining whether the prospective financial information is based on reasonable assumptions.
b. Expressing a limited opinion that the financial information is presented in conformity with generally accepted accounting principles.
c. Deciding whether to perform substantive audit procedures prior to the balance sheet date.
d. Reporting whether material modifications should be made for such information to conform with generally accepted accounting principles.

N91#28. Miller Co. uses the first-in, first-out method of costing for its international subsidiary's inventory and the last-in, first-out method of costing for its domestic inventory. Under these circumstances, Miller should issue an auditor's report with an

a. "Except for" qualified opinion.
b. Unqualified opinion.
c. Explanatory paragraph as to consistency.
d. Opinion modified as to consistency.

N91#29. An auditor may report on condensed financial statements that are derived from complete audited financial statements if the

a. Auditor indicates whether the information in the condensed financial statements is fairly stated in all material respects.
b. Condensed financial statements are presented in comparative form with the prior year's condensed financial statements.
c. Auditor describes the additional review procedures performed on the condensed financial statements.
d. Condensed financial statements are distributed only to management and the board of directors.

M91#38. Green, CPA, is aware that Green's name is to be included in the interim report of National Company, a publicly-held entity. National's quarterly financial statements are contained in the interim report. Green has not audited or reviewed these interim financial statements. Green should request that

I. Green's name not be included in the communication.
II. The financial statements be marked as unaudited with a notation that **no** opinion is expressed on them.

a. I only.
b. II only.
c. Both I and II.
d. Either I or II.

M91#41. An accountant's standard report on a compilation of a projection should **not** include a

a. Statement that the accountant expresses only limited assurance that the results may be achieved.
b. Separate paragraph that describes the limitations on the presentation's usefulness.
c. Statement that a compilation of a projection is limited in scope.
d. Disclaimer of responsibility to update the report for events occurring after the report's date.

M91#42. An auditor was unable to obtain audited financial statements or other evidence supporting an entity's investment in a foreign subsidiary. Between which of the following opinions should the entity's auditor choose?

a. Adverse and unqualified with an explanatory paragraph added.
b. Disclaimer and unqualified with an explanatory paragraph added.
c. Qualified and adverse.
d. Qualified and disclaimer.

M91#43. The adverse effects of events causing an auditor to believe there is substantial doubt about an entity's ability to continue as a going concern would most likely be mitigated by evidence relating to the

a. Ability to expand operations into new product lines in the future.
b. Feasibility of plans to purchase leased equipment at less than market value.
c. Marketability of assets that management plans to sell.
d. Committed arrangements to convert preferred stock to long-term debt.

M91#44. If an auditor is satisfied that there is only a remote likelihood of a loss resulting from the resolution of a matter involving an uncertainty, the auditor should express a(an)

a. Unqualified opinion.
b. Unqualified opinion with a separate explanatory paragraph.
c. Qualified opinion or disclaimer of opinion, depending upon the materiality of the loss.
d. Qualified opinion or disclaimer of opinion, depending on whether the uncertainty is adequately disclosed.

M91#45. When an auditor qualifies an opinion because of the inability to confirm accounts receivable by direct communication with debtors, the wording of the opinion paragraph of the auditor's report should indicate that the qualification pertains to the

a. Limitation on the auditor's scope.
b. Possible effects on the financial statements.
c. Lack of sufficient competent evidential matter.
d. Departure from generally accepted auditing standards.

M91#46. When an auditor qualifies an opinion because of inadequate disclosure, the auditor should describe the nature of the omission in a separate explanatory paragraph and modify the

	Introductory paragraph	*Scope paragraph*	*Opinion paragraph*
a.	Yes	No	No
b.	Yes	Yes	No
c.	No	Yes	Yes
d.	No	No	Yes

M91#48. An auditor includes a separate paragraph in an otherwise unmodified report to emphasize that the entity being reported upon had significant transactions with related parties. The inclusion of this separate paragraph

a. Is appropriate and would **not** negate the unqualified opinion.
b. Is considered an "except for" qualification of the opinion.
c. Violates generally accepted auditing standards if this information is already disclosed in footnotes to the financial statements.
d. Necessitates a revision of the opinion paragraph to include the phrase "with the foregoing explanation."

M91#49. The financial statements of KCP America, a U.S. entity, are prepared for inclusion in the consolidated financial statements of its non-U.S. parent. These financial statements are prepared in conformity with the accounting principles generally accepted in the parent's country and are for use only in that country. How may KCP America's auditor report on these financial statements?

I. A U.S.-style report (unmodified).
II. A U.S.-style report modified to report on the accounting principles of the parent country.
III. The report form of the parent country.

	I	*II*	*III*
a.	Yes	No	No
b.	No	Yes	No
c.	Yes	No	Yes
d.	No	Yes	Yes

M91#50. Compiled financial statements should be accompanied by a report stating that

a. A compilation is limited to presenting in the form of financial statements information that is the representation of management.
b. The accountant has compiled the financial statements in accordance with standards established by the Auditing Standards Board.
c. A compilation is substantially less in scope than a review or an audit in accordance with generally accepted auditing standards.
d. The accountant does **not** express an opinion but expresses only limited assurance on the compiled financial statements.

M91#53. An auditor most likely would issue a disclaimer of opinion because of

a. Inadequate disclosure of material information.
b. The omission of the statement of cash flows.
c. A material departure from generally accepted accounting principles.
d. Management's refusal to furnish written representations.

M91#59. Performing inquiry and analytical procedures is the primary basis for an accountant to issue a

a. Report on compliance with requirements governing major federal assistance programs in accordance with the Single Audit Act.
b. Review report on prospective financial statements that present an entity's expected financial position, given one or more hypothetical assumptions.
c. Management advisory report prepared at the request of a client's audit committee.
d. Review report on comparative financial statements for a nonpublic entity in its second year of operations.

M91#60. Kent is auditing an entity's compliance with requirements governing a major federal financial assistance program in accordance with the Single Audit Act. Kent detected noncompliance with requirements that have a material effect on that program. Kent's report on compliance should express a(an)

a. Unqualified opinion with a separate explanatory paragraph.
b. Qualified opinion or an adverse opinion.
c. Adverse opinion or a disclaimer of opinion.
d. Limited assurance on the items tested.

N90#1. Baker, CPA, was engaged to review the financial statements of Hall Company, a nonpublic entity. Evidence came to Baker's attention that indicated substantial doubt as to Hall's ability to continue as a going concern. The principal conditions and events that caused the substantial doubt have been fully disclosed in the notes to Hall's financial statements. Which of the following statements best describes Baker's reporting responsibility concerning this matter?

a. Baker is **not** required to modify the accountant's review report.
b. Baker is **not** permitted to modify the accountant's review report.
c. Baker should issue an accountant's compilation report instead of a review report.
d. Baker should express a qualified opinion in the accountant's review report.

N90#2. King, CPA, was engaged to audit the financial statements of Newton Company after its fiscal year had ended. King neither observed the inventory count nor confirmed the receivables by direct communication with debtors, but was satisfied concerning both after applying alternative procedures. King's auditor's report most likely contained a(an)

a. Qualified opinion.
b. Disclaimer of opinion.
c. Unqualified opinion.
d. Unqualified opinion with an explanatory paragraph.

N90#3. In which of the following circumstances would an auditor be most likely to express an adverse opinion?

a. Information comes to the auditor's attention that raises substantial doubt about the entity's ability to continue as a going concern.
b. The chief executive officer refuses the auditor access to minutes of board of directors' meetings.
c. Tests of controls show that the entity's internal control structure is so poor that it **cannot** be relied upon.
d. The financial statements are **not** in conformity with the FASB Statements regarding the capitalization of leases.

N90#4. It is **not** appropriate to refer a reader of an auditor's report to a financial statement footnote for details concerning

a. Subsequent events.
b. The pro forma effects of a business combination.
c. Sale of a discontinued operation.
d. The results of confirmation of receivables.

N90#5. Tech Company has disclosed an uncertainty due to pending litigation. The auditor's decision to issue a qualified opinion rather than an unqualified opinion with an explanatory paragraph most likely would be determined by the

a. Lack of sufficient evidence.
b. Inability to estimate the amount of loss.
c. Entity's lack of experience with such litigation.
d. Lack of insurance coverage for possible losses from such litigation.

N90#6. In which of the following situations would an auditor ordinarily issue an unqualified audit opinion without an explanatory paragraph?

a. The auditor wishes to emphasize that the entity had significant related party transactions.
b. The auditor decides to make reference to the report of another auditor as a basis, in part, for the auditor's opinion.
c. The entity issues financial statements that present financial position and results of operations, but omits the statement of cash flows.
d. The auditor has substantial doubt about the entity's ability to continue as a going concern, but the circumstances are fully disclosed in the financial statements.

N90#7. The fourth standard of reporting requires the auditor's report to contain either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. The objective of the fourth standard is to prevent

a. Misinterpretations regarding the degree of responsibility the auditor is assuming.
b. An auditor from reporting on one basic financial statement and **not** the others.
c. An auditor from expressing different opinions on each of the basic financial statements.
d. Restrictions on the scope of the examination, whether imposed by the client, or by the inability to obtain evidence.

N90#8. When there has been a change in accounting principle that materially affects the comparability of the comparative financial statements presented and the auditor concurs with the change, the auditor should

	Concur explicity with the change	*Issue an "except for" qualified opinion*	*Refer to the change in an explanatory paragraph*
a.	No	No	Yes
b.	Yes	No	Yes
c.	Yes	Yes	No
d.	No	Yes	No

N90#9. Accepting an engagement to compile a financial projection for a publicly held company most likely would be inappropriate if the projection were to be distributed to

a. A bank with which the entity is negotiating for a loan.
b. A labor union with which the entity is negotiating a contract.
c. The principal stockholder, to the exclusion of the other stockholders.
d. All stockholders of record as of the report date.

N90#10. Comparative financial statements include the prior year's statements that were audited by a predecessor auditor whose report is not presented. If the predecessor's report was unqualified, the successor should

a. Express an opinion on the current year's statements alone and make **no** reference to the prior year's statements.
b. Indicate in the auditor's report that the predecessor auditor expressed an unqualified opinion.
c. Obtain a letter of representations from the predecessor concerning any matters that might affect the successor's opinion.
d. Request the predecessor auditor to reissue the prior year's report.

N90#11. When reporting on comparative financial statements, which of the following circumstances ordinarily should cause the auditor to change the previously issued opinion on the prior year's financial statements?

a. The prior year's financial statements are restated following a pooling of interests in the current year.
b. A departure from generally accepted accounting principles caused an adverse opinion on the prior year's financial statements and those statements have been properly restated.
c. A change in accounting principle caused the auditor to make a consistency modification in the current year's auditor's report.
d. A scope limitation caused a qualified opinion on the prior year's financial statements but the current year's opinion was properly unqualified.

N90#12. Eagle Company's financial statements contain a departure from generally accepted accounting principles because, due to unusual circumstances, the statements would otherwise be misleading. The auditor should express an opinion that is

a. Unqualified but **not** mention the departure in the auditor's report.
b. Unqualified and describe the departure in a separate paragraph.
c. Qualified and describe the departure in a separate paragraph.
d. Qualified or adverse, depending on materiality, and describe the departure in a separate paragraph.

N90#13. An auditor's report on financial statements prepared in accordance with an other comprehensive basis of accounting should include all of the following **except**

a. An opinion as to whether the basis of accounting used is appropriate under the circumstances.
b. An opinion as to whether the financial statements are presented fairly in conformity with the other comprehensive basis of accounting.

c. Reference to the note to the financial statements that describes the basis of presentation.
d. A statement that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles.

N90#14. Tread Corp. accounts for the effect of a material accounting change prospectively when the inclusion of the cumulative effect of the change is required in the current year. The auditor would choose between expressing a(an)

a. Qualified opinion or a disclaimer of opinion.
b. Disclaimer of opinion or an unqualified opinion with an explanatory paragraph.
c. Unqualified opinion with an explanatory paragraph and an adverse opinion.
d. Adverse opinion and a qualified opinion.

M90#11. An auditor's report would be designated a special report when it is issued in connection with

a. Interim financial information of a publicly held company that is subject to a limited review.
b. Compliance with aspects of regulatory requirements related to audited financial statements.
c. Application of accounting principles to specified transactions.
d. Limited use prospective financial statements such as a financial projection.

M90#12. An explanatory paragraph following the opinion paragraph of an auditor's report describes an uncertainty as follows:

> As discussed in Note X to the financial statements, the Company is a defendant in a lawsuit alleging infringement of certain patent rights and claiming damages. Discovery proceedings are in progress. The ultimate outcome of the litigation cannot presently be determined. Accordingly, no provision for any liability that may result upon adjudication has been made in the accompanying financial statements.

What type of opinion should the auditor express under these circumstances?

a. Unqualified.
b. "Subject to" qualified.
c. "Except for" qualified.
d. Disclaimer.

M90#13. The predecessor auditor, who is satisfied after properly communicating with the successor auditor, has reissued a report because the audit client desires comparative financial statements. The predecessor auditor's report should make

a. Reference to the report of the successor auditor only in the scope paragraph.
b. Reference to the work of the successor auditor in the scope and opinion paragraphs.
c. Reference to both the work and the report of the successor auditor only in the opinion paragraph.
d. No reference to the report or the work of the successor auditor.

M90#14. If a publicly held company issues financial statements that purport to present its financial position and results of operations but omits the statement of cash flows, the auditor ordinarily will express a(an)

a. Unqualified opinion with a separate explanatory paragraph.
b. Disclaimer of opinion.
c. Adverse opinion.
d. Qualified opinion.

M90#15. An auditor's report that refers to the use of an accounting principle at variance with generally accepted accounting principles contains the words, "In our opinion, with the foregoing explanation, the financial statements referred to above present fairly. . . ." This is considered an

a. Adverse opinion.
b. "Except for" qualified opinion.
c. Unqualified opinion with an explanatory paragraph.
d. Example of inappropriate reporting.

M90#16. In which of the following circumstances would an auditor usually choose between issuing a qualified opinion or a disclaimer of opinion?

a. Departure from generally accepted accounting principles.
b. Inadequate disclosure of accounting policies.
c. Inability to obtain sufficient competent evidential matter.
d. Unreasonable justification for a change in accounting principle.

M90#17. An auditor has previously expressed a qualified opinion on the financial statements of a prior period because of a departure from generally accepted accounting principles. The prior-period financial statements are restated in the current period to conform with generally accepted accounting principles. The auditor's updated report on the prior-period financial statements should

a. Express an unqualified opinion concerning the restated financial statements.
b. Be accompanied by the original auditor's report on the prior period.
c. Bear the same date as the original auditor's report on the prior period.
d. Qualify the opinion concerning the restated financial statements because of a change in accounting principle.

M90#18. Under which of the following circumstances would a disclaimer of opinion **not** be appropriate?

a. The auditor is engaged after fiscal year-end and is unable to observe physical inventories or apply alternative procedures to verify their balances.
b. The auditor is unable to determine the amounts associated with illegal acts committed by the client's management.
c. The financial statements fail to contain adequate disclosure concerning related party transactions.
d. The client refuses to permit its attorney to furnish information requested in a letter of audit inquiry.

M90#19. During a review of the financial statements of a nonpublic entity, an accountant becomes aware of a lack of adequate disclosure that is material to the financial statements. If management refuses to correct the financial statement presentations, the accountant should

a. Issue an adverse opinion.
b. Issue an "except for" qualified opinion.
c. Disclose this departure from generally accepted accounting principles in a separate paragraph of the report.
d. Express only limited assurance on the financial statement presentations.

M90#20. Before issuing a report on the compilation of financial statements of a nonpublic entity, the accountant should

a. Apply analytical procedures to selected financial data to discover any material misstatements.
b. Corroborate at least a sample of the assertions management has embodied in the financial statements.
c. Inquire of the client's personnel whether the financial statements omit substantially all disclosures.
d. Read the financial statements to consider whether the financial statements are free from obvious material errors.

M90#22. When a qualified opinion results from a limitation on the scope of the audit, the situation should be described in an explanatory paragraph

a. Preceding the opinion paragraph and referred to only in the scope paragraph of the auditor's report.
b. Following the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report.
c. Following the opinion paragraph and referred to only in the scope paragraph of the auditor's report.
d. Preceding the opinion paragraph and referred to in both the scope and opinion paragraphs of the auditor's report.

M90#23. Which of the following statements concerning prospective financial statements is correct?

a. Only a financial forecast would normally be appropriate for limited use.
b. Only a financial projection would normally be appropriate for general use.
c. Any type of prospective financial statements would normally be appropriate for limited use.
d. Any type of prospective financial statements would normally be appropriate for general use.

N89#2. When there is a significant change in accounting principle, an auditor's report should refer to the lack of consistency in

a. The scope paragraph.
b. An explanatory paragraph between the second paragraph and the opinion paragraph.
c. The opinion paragraph.
d. An explanatory paragraph following the opinion paragraph.

N89#3. How are management's responsibility and the auditor's responsibility represented in the standard auditor's report?

	Management's responsibility	*Auditor's responsibility*
a.	Explicitly	Explicitly
b.	Implicitly	Implicitly
c.	Implicitly	Explicitly
d.	Explicitly	Implicitly

N89#4. Restrictions imposed by a client prohibit the observation of physical inventories, which account for 35% of all assets. Alternative audit procedures cannot be applied, although the auditor was able to examine satisfactory evidence for all other items in the financial statements. The auditor should issue a(an)

a. "Except for" qualified opinion.
b. Disclaimer of opinion.
c. Unqualified opinion with a separate explanatory paragraph.
d. Unqualified opinion with an explanation in the scope paragraph.

N89#5. When an accountant performs more than one level of service (for example, a compilation and a review, or a compilation and an audit) concerning the financial statements of a nonpublic entity, the accountant generally should issue the report that is appropriate for

a. The lowest level of service rendered.
b. The highest level of service rendered.
c. A compilation engagement.
d. A review engagement.

N89#6. An accountant who reviews the financial statements of a nonpublic entity should issue a report stating that a review

a. Is substantially less in scope than an audit.
b. Provides negative assurance that the internal control structure is functioning as designed.
c. Provides only limited assurance that the financial statements are fairly presented.
d. Is substantially more in scope than a compilation.

N89#7. A limitation on the scope of an auditor's examination sufficient to preclude an unqualified opinion will usually result when management

a. Presents financial statements that are prepared in accordance with the cash receipts and disbursements basis of accounting.
b. States that the financial statements are **not** intended to be presented in conformity with generally accepted accounting principles.
c. Does **not** make the minutes of the Board of Directors' meetings available to the auditor.
d. Asks the auditor to report on the balance sheet and **not** on the other basic financial statements.

N89#8. Grant Company's financial statements adequately disclose uncertainties that concern future events, the outcome of which are **not** susceptible of reasonable estimation. The auditor's report should include a(an)

a. Unqualified opinion.
b. "Subject to" qualified opinion.
c. "Except for" qualified opinion.
d. Adverse opinion.

N89#9. An auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. If the entity's disclosures concerning this matter are adequate, the audit report may include a(an)

	Disclaimer of opinion	*"Except for" qualified opinion*
a.	Yes	Yes
b.	No	No
c.	No	Yes
d.	Yes	No

N89#10. An auditor may issue a qualified opinion under which of the following circumstances?

	Lack of sufficient competent evidential matter	*Restrictions on the scope of the audit*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N89#11. When reporting on comparative financial statements, an auditor ordinarily should change the previously issued opinion on the prior year's financial statements if

a. The prior year's opinion was unqualified and the opinion on the current year's financial statements is modified due to a lack of consistency.
b. The prior year's financial statements are restated following a pooling of interests in the current year.
c. The prior year's financial statements are restated to conform with generally accepted accounting principles.
d. The auditor is a predecessor auditor who has been requested by a former client to reissue the previously issued report.

N89#13. An auditor should disclose the substantive reasons for expressing an adverse opinion in an explanatory paragraph

a. Preceding the scope paragraph.
b. Preceding the opinion paragraph.
c. Following the opinion paragraph.
d. Within the notes to the financial statements.

N89#14. When management does **not** provide reasonable justification that a change in accounting principle is preferable and it presents comparative financial statements, the auditor should express a qualified opinion

a. Only in the year of the accounting principle change.
b. Each year that the financial statements initially reflecting the change are presented.
c. Each year until management changes back to the accounting principle formerly used.
d. Only if the change is to an accounting principle that is **not** generally accepted.

N89#15. When an accountant compiles a nonpublic entity's financial statements that omit substantially all disclosures required by generally accepted accounting principles, the accountant should indicate in the compilation report that the financial statements are

a. Restricted for internal use only by the entity's management.
b. Not to be given to financial institutions for the purpose of obtaining credit.
c. Compiled in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.
d. Not designed for those who are uninformed about the omitted disclosures.

N89#16. When an independent CPA is associated with the financial statements of a publicly held entity but has **not** audited or reviewed such statements, the appropriate form of report to be issued must include a(an)

a. Compilation report.
b. Disclaimer of opinion.
c. Unaudited association report.
d. Qualified opinion.

N89#17. The objective of a review of interim financial information is to provide an accountant with a basis for reporting whether

a. The financial statements are presented fairly in accordance with generally accepted accounting principles.
b. A reasonable basis exists for expressing an updated opinion regarding the financial statements that were previously audited.
c. Material modifications should be made to conform with generally accepted accounting principles.
d. The financial statements are presented fairly in accordance with standards of interim reporting.

N89#18. When an auditor is requested to express an opinion on the rental and royalty income of an entity, the auditor may

a. Not accept the engagement because to do so would be tantamount to agreeing to issue a piecemeal opinion.
b. Not accept the engagement unless also engaged to audit the full financial statements of the entity.
c. Accept the engagement provided the auditor's opinion is expressed in a special report.
d. Accept the engagement provided distribution of the auditor's report is limited to the entity's management.

N89#19. Negative assurance may be expressed when an accountant is requested to report on the

a. Compilation of prospective financial statements.
b. Compliance with the provisions of the Foreign Corrupt Practices Act.
c. Results of applying agreed-upon procedures to an account within unaudited financial statements.
d. Audit of historical financial statements.

N89#20. When an accountant compiles projected financial statements, the accountant's report should include a separate paragraph that

a. Describes the differences between a projection and a forecast.
b. Identifies the accounting principles used by management.
c. Expresses limited assurance that the actual results may be within the projection's range.
d. Describes the limitations on the projection's usefulness.

N89#21. When an accountant examines a financial forecast that fails to disclose several significant assumptions used to prepare the forecast, the accountant should describe the assumptions in the accountant's report and issue a(an)

a. "Except for" qualified opinion.
b. "Subject to" qualified opinion.
c. Unqualified opinion with a separate explanatory paragraph.
d. Adverse opinion.

N89#22. Soon after Boyd's audit report was issued, Boyd learned of certain related party transactions that occurred during the year under audit. These transactions were not disclosed in the notes to the financial statements. Boyd should

a. Plan to audit the transactions during the next engagement.
b. Recall all copies of the audited financial statements.
c. Determine whether the lack of disclosure would affect the auditor's report.
d. Ask the client to disclose the transactions in subsequent interim statements.

N89#24. Management of Hill Company has decided not to account for a material transaction in accordance with the provisions of an FASB Standard. In setting forth its reasons in a note to the financial statements, management has clearly demonstrated that due to unusual circumstances the financial statements presented in accordance with the FASB Standard would be misleading. The auditor's report should include a separate explanatory paragraph and contain a(an)

a. "Except for" qualified opinion.
b. "Subject to" qualified opinion.
c. Adverse opinion.
d. Unqualified opinion.

M89#46. A limitation on the scope of an auditor's examination sufficient to preclude an unqualified opinion will always result when management

a. Engages the auditor after the year-end physical inventory count is completed.
b. Fails to correct a material internal control weakness that had been identified during the prior year's audit.
c. Refuses to furnish a management representation letter to the auditor.
d. Prevents the auditor from reviewing the working papers of the predecessor auditor.

M89#47. An accountant has been asked to compile the financial statements of a nonpublic company on a prescribed form that omits substantially all the disclosures required by generally accepted accounting principles. If the prescribed form is a standard preprinted form adopted by the company's industry trade association, and is to be transmitted only to such association, the accountant

a. Need **not** advise the industry trade association of the omission of all disclosures.
b. Should disclose the details of the omissions in separate paragraphs of the compilation report.
c. Is precluded from issuing a compilation report when all disclosures are omitted.
d. Should express limited assurance that the financial statements are free of material misstatements.

M89#48. On September 30, 1988, Miller was asked to reissue an auditor's report, dated March 31, 1988, on a client's financial statements for the year ended December 31, 1987. Miller will submit the reissued report to the client in a document that contains information in addition to the client's basic financial statements. However, Miller discovered that the client suffered substantial losses on receivables resulting from conditions that occurred since March 31, 1988. Miller should

a. Request the client to disclose the event in a separate, appropriately labeled note to the financial statements and reissue the original report with its original date.
b. Request the client to restate the financial statements and reissue the original report with a dual date.
c. Reissue the original report with its original date without regard to whether the event is disclosed in a separate note to the financial statements.
d. Not reissue the original report but issue a "subject to" qualified opinion that discloses the event in a separate explanatory paragraph.

M89#49. An auditor who qualifies an opinion because of an insufficiency of evidential matter should describe the limitation in an explanatory paragraph. The auditor should also refer to the limitation in the

	Scope paragraph	*Opinion paragraph*	*Notes to the financial statements*
a.	Yes	No	Yes
b.	No	Yes	No
c.	Yes	Yes	No
d.	Yes	Yes	Yes

M89#50. An auditor who conducts an examination in accordance with generally accepted auditing standards and concludes that the financial statements are fairly presented in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, such as the cash basis of accounting, should issue a

a. Special report.
b. Disclaimer of opinion.
c. Review report.
d. Qualified opinion.

M89#51. An auditor concludes that there is a material inconsistency in the other information in an annual report to shareholders containing audited financial statements. If the auditor concludes that the financial statements do **not** require revision, but the client refuses to revise or eliminate the material inconsistency, the auditor may

a. Issue an "except for" qualified opinion after discussing the matter with the client's board of directors.
b. Consider the matter closed since the other information is **not** in the audited financial statements.
c. Disclaim an opinion on the financial statements after explaining the material inconsistency in a separate explanatory paragraph.
d. Revise the auditor's report to include a separate explanatory paragraph describing the material inconsistency.

M89#52. An auditor may **not** issue a qualified opinion when

a. A scope limitation prevents the auditor from completing an important audit procedure.
b. The auditor's report refers to the work of a specialist.
c. An accounting principle at variance with generally accepted accounting principles is used.
d. The auditor lacks independence with respect to the audited entity.

M89#54. Unaudited financial statements for the prior year presented in comparative form with audited financial statements for the current year should be clearly marked to indicate their status and

I. The report on the prior period should be reissued to accompany the current period report.
II. The report on the current period should include as a separate paragraph a description of the responsibility assumed for the prior period's financial statements.

a. I only.
b. II only.
c. Both I and II.
d. Either I or II.

M89#55. When a publicly-held company refuses to include in its audited financial statements any of the segment information that the auditor believes is required, the auditor should issue a(an)

a. Unqualified opinion with a separate explanatory paragraph emphasizing the matter.
b. "Except for" qualified opinion because of inadequate disclosure.
c. Adverse opinion because of the lack of conformity with generally accepted accounting principles.
d. Disclaimer of opinion because of the significant scope limitation.

M89#58. An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that

a. Distribution of the report is to be restricted to the specified users involved.
b. The prospective financial statements are also examined.
c. Responsibility for the adequacy of the procedures performed is taken by the accountant.
d. Negative assurance is expressed on the prospective financial statements taken as a whole.

M89#59. When a client will **not** permit inquiry of outside legal counsel, the audit report will ordinarily contain a(an)

a. Disclaimer of opinion.
b. "Except for" qualified opinion.
c. "Subject to" qualified opinion.
d. Unqualified opinion with a separate explanatory paragraph.

N88#16. An auditor's report includes the following statement:

"The financial statements do not present fairly the financial position, results of operations, or cash flows in conformity with generally accepted accounting principles."

This auditor's report was most likely issued in connection with financial statements that are

a. Inconsistent.
b. Based on prospective financial information.
c. Misleading.
d. Affected by a material uncertainty.

N88#17. An auditor includes a middle paragraph in an otherwise unqualified report to emphasize that the financial statements are not comparable to those of prior years due to a court-ordered divestiture that is already fully explained in the notes to the financial statements. The inclusion of this paragraph

a. Should be followed by an "except for" consistency modification in the opinion paragraph.
b. Requires a revision of the opinion paragraph to include the phrase "with the foregoing explanation."
c. Is **not** appropriate and may confuse the readers or lead them to believe the report was qualified.
d. Is appropriate and would **not** negate the unqualified opinion.

N88#18. Green, CPA, is requested to render an opinion on the application of accounting principles by an entity that is audited by another CPA. Green may

a. Not accept such an engagement because to do so would be considered unethical.
b. Not accept such an engagement because Green would lack the necessary information on which to base an opinion without conducting an audit.
c. Accept the engagement but should form an independent opinion without consulting with the continuing CPA.
d. Accept the engagement but should consult with the continuing CPA to ascertain all the available facts relevant to forming a professional judgment.

N88#19. An auditor may reasonably issue an "except for" qualified opinion for

	Inadequate disclosure	*Scope limitation*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N88#20. An auditor may reasonably issue a "subject to" qualified opinion for

	Lack of consistency	*Departure from generally accepted accounting principles*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N88#21. An auditor did not examine an entity's financial statements for the preceding year. Inadequate financial records precluded an opinion as to asset and liability balances at the beginning of the current year and the consistent application of generally accepted accounting principles. The auditor should explain the inadequacies in the financial records in

a. A middle paragraph, the lack of consistency in the opinion paragraph, and express a disclaimer of opinion on the financial statements.
b. A middle paragraph, the lack of consistency also in the middle paragraph, and express an opinion only on the balance sheet.
c. The opinion paragraph, the lack of consistency also in the opinion paragraph, and express a disclaimer of opinion on the financial statements.
d. The opinion paragraph, the lack of consistency also in the opinion paragraph, and express an opinion only on the balance sheet.

N88#22. Each page of a nonpublic entity's financial statements reviewed by an accountant should include the following reference:

a. See Accountant's Review Report.
b. Reviewed, **No** Accountant's Assurance Expressed.

c. See Accompanying Accountant's Footnotes.
d. Reviewed, **No** Material Modifications Required.

N88#24. An accountant may accept an engagement to apply agreed-upon procedures that are **not** sufficient to express an opinion on one or more specified accounts or items of a financial statement provided that
a. The accountant's report does **not** enumerate the procedures performed.
b. The financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.
c. Distribution of the accountant's report is restricted.
d. The accountant is also the entity's continuing auditor.

N88#25. Reports are considered special reports when issued in connection with
a. Compliance with aspects of regulatory requirements related to audited financial statements.
b. Pro forma financial presentations designed to demonstrate the effect of hypothetical transactions.
c. Feasibility studies presented to illustrate an entity's results of operations.
d. Interim financial information reviewed to determine whether material modifications should be made to conform with generally accepted accounting principles.

N88#27. Prospective financial information presented in the format of historical financial statements that omit either gross profit or net income is deemed to be a
a. Partial presentation.
b. Projected balance sheet.
c. Financial forecast.
d. Financial projection.

N88#58. Compiled financial statements should be accompanied by a report stating all the following **except**
a. The accountant does **not** express an opinion or any other form of assurance on the financial statements.
b. A compilation is substantially less in scope than an examination in accordance with generally accepted auditing standards.
c. The accountant compiled the financial statements in accordance with standards established by the AICPA.
d. A compilation is limited to presenting in the form of financial statements information that is the representation of management.

M88#25. An auditor reporting on comparative financial statements is **not** required to include an explanatory paragraph in the auditor's report if the opinion paragraph is modified because of a(an)
a. Change in accounting principle.
b. Scope limitation.
c. Disclaimer of opinion.
d. Uncertainty affecting the financial statements.

M88#41. An auditor did not observe a client's taking of beginning physical inventory and was unable to become satisfied about the inventory by means of other auditing procedures. Assuming **no** other scope limitations or reporting problems, the auditor could issue an unqualified opinion on the current year's financial statements for
a. The balance sheet only.
b. The income statement only.
c. The income and retained earnings statements only.
d. All of the financial statements.

M88#43. Which of the following representations does an auditor make explicitly and which implicitly when issuing an unqualified opinion?

	Conformity with GAAP	*Adequacy of disclosure*
a.	Explicitly	Explicitly
b.	Implicitly	Implicitly
c.	Implicitly	Explicitly
d.	Explicitly	Implicitly

M88#45. An auditor's report expresses an unqualified opinion and includes a middle paragraph that emphasizes a matter included in the notes to the financial statements. The auditor's report would be deficient if the middle paragraph states that the entity
a. Has changed from the completed-contract method to the percentage of completion method of accounting for long-term construction contracts.
b. Has had a significant subsequent event.
c. Has accounting reclassifications that enhance the comparability between the current and prior year.
d. Is a component of a larger business enterprise.

M88#47. For a particular entity's financial statements to be presented fairly in conformity with generally accepted accounting principles, it is **not** required that the principles selected
a. Be appropriate in the circumstances for the particular entity.
b. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
c. Present information in the financial statements that is classified and summarized in a reasonable manner.
d. Be applied on a basis consistent with those followed in the prior year.

M88#48. Which of the following circumstances requires modification of the accountant's report on a review of interim financial information of a publicly held entity?

	An uncertainty	*Inadequate disclosure*
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

M88#49. An auditor's report issued in connection with which of the following is generally **not** considered to be a special report?

a. Compliance with aspects of contractual agreements unrelated to audited financial statements.
b. Specified elements, accounts, or items of a financial statement presented in a document.
c. Financial statements prepared in accordance with an entity's income tax basis.
d. Financial information presented in a prescribed schedule that requires a prescribed form of auditor's report.

B. Other Reporting Considerations

M92#12. Wilson, CPA, completed the field work of the audit of Abco's December 31, 1991, financial statements on March 6, 1992. A subsequent event requiring adjustment to the 1991 financial statements occurred on April 10, 1992, and came to Wilson's attention on April 24, 1992. If the adjustment is made without disclosure of the event, Wilson's report ordinarily should be dated

a. March 6, 1992.
b. April 10, 1992.
c. April 24, 1992.
d. Using dual dating.

M92#14. What is an auditor's responsibility for supplementary information required by the GASB that is placed outside the basic financial statements?

a. Label the information as unaudited and expand the auditor's report to include a disclaimer on the information.
b. Add an explanatory paragraph to the auditor's report and refer to the information as "required supplementary information."
c. Apply limited procedures to the information and report deficiencies in, or the omission of, the information.
d. Audit the required supplementary information in accordance with generally accepted governmental auditing standards.

M92#15. Should an auditor communicate the following matters to an audit committee of a public entity?

	Significant audit adjustments recorded by the entity	*Management's consultation with other accountants about significant accounting matters*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M92#21. How does the Securities Act of 1933, which imposes civil liability on auditors for misrepresentations or omissions of material facts in a registration statement, expand auditors' liability to purchasers of securities beyond that of common law?

a. Purchasers only have to prove loss caused by reliance on audited financial statements.
b. Privity with purchasers is **not** a necessary element of proof.
c. Purchasers have to prove either fraud or gross negligence as a basis for recovery.
d. Auditors are held to a standard of care described as "professional skepticism."

N91#20. After issuing a report, an auditor has **no** obligation to make continuing inquiries or perform other procedures concerning the audited financial statements, unless

a. Information, which existed at the report date and may affect the report, comes to the auditor's attention.
b. Management of the entity requests the auditor to reissue the auditor's report.
c. Information about an event that occurred after the end of field work comes to the auditor's attention.
d. Final determinations or resolutions are made of contingencies that had been disclosed in the financial statements.

N91#30. In which of the following situations would a principal auditor **least** likely make reference to another auditor who audited a subsidiary of the entity?

a. The other auditor was retained by the principal auditor and the work was performed under the principal auditor's guidance and control.
b. The principal auditor finds it impracticable to review the other auditor's work or otherwise be satisfied as to the other auditor's work.
c. The financial statements audited by the other auditor are material to the consolidated financial statements covered by the principal auditor's opinion.
d. The principal auditor is unable to be satisfied as to the independence and professional reputation of the other auditor.

N91#31. If information accompanying the basic financial statements in an auditor-submitted document has been subjected to auditing procedures, the auditor may include in the auditor's report on the financial statements an opinion that the accompanying information is fairly stated in

a. Conformity with standards established by the AICPA.
b. Accordance with generally accepted auditing standards.
c. Conformity with generally accepted accounting principles.
d. All material respects in relation to the basic financial statements taken as a whole.

M91#54. Comfort letters ordinarily are addressed to

a. Creditor financial institutions.
b. The client's audit committee.
c. The Securities and Exchange Commission.
d. Underwriters of securities.

M91#55. Which of the following matters is an auditor required to communicate to an entity's audit committee?

	Significant audit adjustments	*Changes in significant accounting policies*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N90#15. An annual shareholders' report includes audited financial statements and contains a management report asserting that the financial statements are the responsibility of management. Is it permissible for the auditor's report to refer to the management report?

a. No, because the reference may lead to the belief that the auditor is providing assurances about management's representations.
b. No, because the auditor has **no** responsibility to read the other information in a document containing audited financial statements.
c. Yes, provided the reference is included in a separate explanatory paragraph of the auditor's report.
d. Yes, provided the auditor reads the management report and discovers **no** material misrepresentation of fact.

M90#24. When an independent accountant's report based on a review of interim financial information is presented in a registration statement, a prospectus should include a statement about the accountant's involvement. This statement should clarify that the

a. Accountant is **not** an "expert" within the meaning of the Securities Act of 1933.
b. Accountant's review report is **not** a "part" of the registration statement within the meaning of the Securities Act of 1933.
c. Accountant performed only limited auditing procedures on the interim financial statements.
d. Accountant's review was performed in accordance with standards established by the American Institute of CPAs.

M90#25. If management declines to present supplementary information required by the Governmental Accounting Standards Board (GASB), the auditor should issue a(an)

a. Adverse opinion.
b. Qualified opinion with an explanatory paragraph.
c. Unqualified opinion.
d. Unqualified opinion with an additional explanatory paragraph.

N89#1. When a principal auditor decides to make reference to another auditor's examination, the principal auditor's report should always indicate clearly, in the introductory, scope, and opinion paragraphs, the

a. Magnitude of the portion of the financial statements examined by the other auditor.
b. Disclaimer of responsibility concerning the portion of the financial statements examined by the other auditor.
c. Name of the other auditor.
d. Division of responsibility.

N89#23. A former client requests a predecessor auditor to reissue an audit report on a prior period's financial statements. The financial statements are not restated and the report is not revised. What date(s) should the predecessor auditor use in the reissued report?

a. The date of the prior-period report.
b. The date of the client's request.
c. The date of reissue.
d. The dual-dates.

M89#60. An auditor may issue the standard audit report when the

a. Auditor refers to the findings of a specialist.
b. Financial statements are derived and condensed from complete audited financial statements that are filed with a regulatory agency.
c. Financial statements are prepared on the cash receipts and disbursements basis of accounting.
d. Principal auditor assumes responsibility for the work of another auditor.

N88#14. The Securities and Exchange Commission has authority to

a. Prescribe specific auditing procedures to detect fraud concerning inventories and accounts receivable of companies engaged in interstate commerce.
b. Deny lack of privity as a defense in third-party actions for gross negligence against the auditors of public companies.
c. Determine accounting principles for the purpose of financial reporting by companies offering securities to the public.
d. Require a change of auditors of governmental entities after a given period of years as a means of ensuring auditor independence.

N88#28. After an audit report containing an unqualified opinion on a non-public client's financial statements was issued, the client decided to sell the shares of a subsidiary that accounts for 30% of its revenue and 25% of its net income. The auditor should

a. Determine whether the information is reliable and, if determined to be reliable, request that revised financial statements be issued.
b. Notify the entity that the auditor's report may **no** longer be associated with the financial statements.
c. Describe the effects of this subsequently discovered information in a communication with persons known to be relying on the financial statements.
d. Take **no** action because the auditor has **no** obligation to make any further inquiries.

N88#29. The principal auditor is satisfied with the independence and professional reputation of the other auditor who has audited the financial statements of a subsidiary. To indicate the division of responsibility, the principal auditor should modify

a. Only the opinion paragraph of the report.
b. Only the opinion paragraph of the report and include an explanatory middle paragraph.
c. Only the scope paragraph of the report.
d. Both the scope and opinion paragraphs of the report.

M88#50. Information accompanying the basic financial statements in an auditor-submitted document should **not** include

a. An analysis of inventory by location.
b. A statement that the allowance for doubtful accounts is adequate.
c. A statement that the depreciable life of a new asset is 20 years.
d. An analysis of revenue by product line.

SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. Professional Responsibilities

A. General Standards and Code of Professional Conduct

M92#56 a
N91# 2 a
N91# 9 b
M91#52 c
M91#57 b
N90#37 d
N90#39 d
M90#46 b
M90#47 b
N89#49 b
N89#56 c
N89#57 c
M89# 2 c
M89# 3 a
N88# 2 d
N88# 3 a
N88# 4 a
N88# 5 c
M88#51 c
M88#52 a
M88#53 d

B. Control of the Audit

M92#57 d
M92#58 b
N91# 1 b
N91# 3 b
N91# 4 a
N91# 5 c
N91# 6 a
N91# 7 b
N91# 8 d
N90#36 a
M90# 3 d
M90#50 b
M90#51 c
M90#52 a
M90#53 c
M90#54 b
M89# 4 c
M89# 5 d
N88# 6 a
N88#11 b
N88#23 b
N88#33 b
M88#54 d
M88#55 b
M88#56 c

C. Other Responsibilities

M92#59 d
M92#60 a
N91#10 a
N91#11 c
N91#12 a
N91#13 d
N91#14 c
N91#15 c
M91#51 b
M91#56 c
M91#58 b
N90#38 a
M90#48 b
M90#49 a
M90#55 d
M90#56 d
M90#57 b
M90#58 a
M90#59 d
N89#59 d
N89#60 a
N88# 9 b
N88#10 d
N88#12 a
N88#15 c
N88#30 c
M88#58 a
M88#59 b

II. Internal Control

A. Definitions and Basic Concepts

M92#36 d
M92#37 a
M92#38 b
N91#32 c
N91#33 d
M91#21 d
M91#22 b
M91#23 b
N90#41 b
N90#42 d
M90#27 a
M90#28 a
N89#36 d
N89#37 b
N89#38 a
M89# 6 d
M89# 7 c
N88#31 b
N88#32 b
N88#36 a

B. Consideration of the Internal Control Structure

M92#39 b
M92#40 d
M92#41 c
M92#42 c
M92#43 c
N91#34 c
N91#35 d
N91#36 b
M91#25 d
M91#26 a
M91#27 b
N90#43 d
N90#44 d
N90#45 c
N90#46 a
N90#47 b
M90#29 b
M90#30 d
M90#31 a
M90#33 c
N89#39 c
N89#40 b
N89#41 b
N89#42 a
M89# 8 d
M89# 9 b
M89#10 c
M89#11 a
M89#12 b
M89#13 b
N88#34 a
N88#38 b
N88#39 c
N88#49 b
M88# 3 c
M88# 6 b
M88# 7 c
M88# 8 d

C. Cycles

M92#44 d
M92#45 c
M92#46 d
M92#47 b
M92#48 a
M92#49 a
N91#38 d
N91#39 b
N91#40 a
N91#41 b
M91#28 c
M91#29 c
M91#30 c
M91#31 b
M91#32 d
N90#48 c
N90#49 a
N90#50 c
N90#51 d
N90#52 d
N90#53 b
N90#54 d
M90#35 b
M90#36 c
M90#37 c
M90#38 c

M90#39 d
N89#45 d
N89#46 d
N89#47 d
N89#48 b
M89#14 c
M89#18 b
M89#19 c
N88#40 b
N88#41 a
N88#42 a
N88#43 b
N88#44 c
N88#45 d
N88#46 a
M88# 9 b
M88#10 a
M88#20 b

D. Other Considerations

M92#50 d
M92#51 b
M92#52 b
M92#53 d
M92#54 d
M92#55 b
N91#43 d
M91#33 a
M91#34 d
M91#35 d
M91#36 b
M91#37 c
M91#39 b
M91#40 a
M91#47 a
N90#55 b
N90#56 c
N90#57 a
N90#58 a
N90#59 a
N90#60 b
M90#40 d
M90#41 a
M90#42 b
M90#43 b
M90#44 a
M90#45 b
N89#50 a
N89#51 d
N89#52 c
N89#54 d
N89#55 d
M89#20 d
M89#21 b
M89#22 a
M89#23 c
M89#24 a
M89#25 b
N88#35 d
N88#47 c
N88#48 c
N88#60 b
M88#15 d

III. Evidence and Procedures

A. Audit Evidence

M92#13 b
M92#16 a
M92#17 b
M92#18 d
M92#19 d
M92#20 c
M92#22 a
M92#23 d
N91#37 a
N91#42 d
N91#44 b
N91#45 b
N91#46 d
N91#47 a
N91#48 d
N91#60 b
M91# 1 d
M91# 2 d
M91# 3 b
M91# 4 c
M91# 5 c
M91# 6 d
M91# 7 b
N90#16 c
N90#17 c
N90#18 a
N90#19 a
N90#20 c
N90#21 c
N90#22 a
N90#23 d
M90# 1 b
M90# 2 a
M90# 5 b
N89#27 c
M89# 1 a
M89#27 c
M89#28 a
M89#29 a
M89#30 c
M89#34 d
N88#52 d
N88#53 c
M88#21 a
M88#22 b
M88#24 c
M88#46 a

B. Specific Audit Objectives and Procedures

M92#24 c
M92#25 c
M92#26 b
M92#27 b
M92#28 a
N91#49 d
N91#50 c
N91#51 b
N91#52 d
N91#53 c
N91#54 c
M91# 8 b
M91# 9 a
M91#10 c
M91#11 d
M91#12 a
M91#13 a
N90#24 c
N90#26 c
M90# 6 c
M90# 7 c
M90#10 b
N89#28 a
N89#29 a
N89#30 d
M89#33 d
M89#35 b
M89#36 b
M89#37 a
N88#54 b
N88#55 a
N88#56 c
M88#26 b
M88#27 d
M88#28 b
M88#29 b
M88#39 c

C. Other Specific Audit Topics

M92#29 d
M92#30 b
M92#31 c
M92#32 b
M92#33 b
N91#24 c
N91#55 b
N91#56 c
N91#57 c
M91#14 c
M91#15 a
M91#16 c
M91#17 c
M91#18 a
N90#28 d
N90#29 d
N90#30 b
N90#31 c
N90#32 c
N90#33 b
N90#34 c
N90#35 c
M90# 8 d
M90# 9 a
N89#31 c
N89#32 a
N89#33 a
M89#39 c
M89#40 c
M89#41 d
M89#42 d
M89#43 d
M89#44 b
N88#57 a
N88#59 b
M88#17 b
M88#33 d
M88#34 a
M88#35 d
M88#36 d
M88#37 b
M88#38 d

D. Review and Compilation Procedures

M92#34 b
M92#35 c
N91#58 a
N91#59 a
M91#19 a
M91#20 b
M90# 4 a
N89#35 c
M89#45 a
M88#40 a

IV. Reporting

A. Reporting Standards and Types of Reports

M92# 1 a
M92# 2 d
M92# 3 c
M92# 4 a
M92# 5 c
M92# 6 d
M92# 7 a
M92# 8 a
M92# 9 a
M92#10 b
M92#11 b
N91#16 c
N91#17 d
N91#18 b
N91#19 d
N91#21 d
N91#22 d
N91#23 c
N91#25 b
N91#26 b
N91#27 d
N91#28 b
N91#29 a
M91#38 d
M91#41 a
M91#42 d
M91#43 c
M91#44 a
M91#45 b
M91#46 d
M91#48 a
M91#49 d
M91#50 a
M91#53 d
M91#59 d
M91#60 b
N90# 1 a
N90# 2 c
N90# 3 d
N90# 4 d
N90# 5 a
N90# 6 b
N90# 7 a
N90# 8 a
N90# 9 d
N90#10 b
N90#11 b
N90#12 b
N90#13 a
N90#14 d
M90#11 b
M90#12 a
M90#13 d
M90#14 d
M90#15 d
M90#16 c
M90#17 a
M90#18 c
M90#19 c
M90#20 d
M90#22 d
M90#23 c
N89# 2 d
N89# 3 a
N89# 4 b
N89# 5 b
N89# 6 a
N89# 7 c
N89# 8 a
N89# 9 d
N89#10 a
N89#11 c
N89#13 b
N89#14 b
N89#15 d
N89#16 b
N89#17 c
N89#18 c
N89#19 c
N89#20 d
N89#21 d
N89#22 c
N89#24 d
M89#46 c
M89#47 a
M89#48 a
M89#49 c
M89#50 a
M89#51 d
M89#52 d
M89#54 d
M89#55 b
M89#58 a
M89#59 a
N88#16 c
N88#17 d
N88#18 d
N88#19 a
N88#20 d
N88#21 b
N88#22 a
N88#24 c
N88#25 a
N88#27 a
N88#58 b
M88#25 a
M88#41 a
M88#43 d
M88#45 a
M88#47 d
M88#48 d
M88#49 a

B. Other Reporting Considerations

M92#12 a
M92#14 c
M92#15 a
M92#21 b
N91#20 a
N91#30 a
N91#31 d
M91#54 d
M91#55 a
N90#15 a
M90#24 b
M90#25 d
N89# 1 d
N89#23 a
M89#60 d
N88#14 c
N88#28 d
N88#29 d
M88#50 b

IV. Reporting

A. Reporting Standards and Types of Reports

M92
Number 2 (Estimated time —— 15 to 25 minutes)

Instructions

Question Number 2 consists of 7 items. Select the **best** answer for each item. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Answer all items.** Your grade will be based on the total number of correct answers.

Required:
Items 61 through 67 present various independent factual situations an auditor might encounter in conducting an audit. List A represents the types of opinions the auditor ordinarily would issue and List B represents the report modifications (if any) that would be necessary. For each situation, select one response from List A and one from List B and blacken the corresponding ovals on the Objective Answer Sheet. Select as the **best** answer for each item, the action the auditor normally would take. The types of opinions in List A and the report modifications in List B may be selected once, more than once, or not at all.

Assume:

- The auditor is independent.
- The auditor previously expressed an unqualified opinion on the prior year's financial statements.
- Only single-year (not comparative) statements are presented for the current year.
- The conditions for an unqualified opinion exist unless contradicted in the factual situations.
- The conditions stated in the factual situations are material.
- No report modifications are to be made except in response to the factual situation.

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

Item

99. The financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

Answer Sheet

	List A							List B										
Item	Types of Opinions (select one)							Report Modifications (select one)										
99	(A)	●	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)	(L)	(M)	(N)	(O)	(P)	●

M92
Number 2 (continued)

Items to be Answered:

61. In auditing the long-term investments account, an auditor is unable to obtain audited financial statements for an investee located in a foreign country. The auditor concludes that sufficient competent evidential matter regarding this investment cannot be obtained.

62. Due to recurring operating losses and working capital deficiencies, an auditor has substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. However, the financial statement disclosures concerning these matters are adequate.

63. A principal auditor decides to take responsibility for the work of another CPA who audited a wholly-owned subsidiary of the entity and issued an unqualified opinion. The total assets and revenues of the subsidiary represent 17% and 18%, respectively, of the total assets and revenues of the entity being audited.

64. An entity issues financial statements that present financial position and results of operations but omits the related statement of cash flows. Management discloses in the notes to the financial statements that it does not believe the statement of cash flows to be a useful financial statement.

65. An entity changes its depreciation method for production equipment from the straight-line to a units-of-production method based on hours of utilization. The auditor concurs with the change although it has a material effect on the comparability of the entity's financial statements.

66. An entity is a defendant in a lawsuit alleging infringement of certain patent rights. However, the ultimate outcome of the litigation cannot be reasonably estimated by management. The auditor believes there is a reasonable possibility of a significantly material loss, but the lawsuit is adequately disclosed in the notes to the financial statements.

67. An entity discloses in the notes to the financial statements certain lease obligations. The auditor believes that the failure to capitalize these leases is a departure from generally accepted accounting principles.

List A	*List B*
Types of Opinions	**Report Modifications**
A. An "except for" qualified opinion	H. Describe the circumstances in an explanatory paragraph *preceding* the opinion paragraph *without modifying* the three standard paragraphs.
B. An unqualified opinion	I. Describe the circumstances in an explanatory paragraph *following* the opinion paragraph *without modifying* the three standard paragraphs.
C. An adverse opinion	J. Describe the circumstances in an explanatory paragraph *preceding* the opinion paragraph and *modify* the *opinion* paragraph.
D. A disclaimer of opinion	K. Describe the circumstances in an explanatory paragraph *following* the opinion paragraph and *modify* the *opinion* paragraph.
E. Either an "except for" qualified opinion or an adverse opinion	L. Describe the circumstances in an explanatory paragraph *preceding* the opinion paragraph and *modify* the *scope* and *opinion* paragraphs.
F. Either a disclaimer of opinion or an "except for" qualified opinion	M. Describe the circumstances in an explanatory paragraph *following* the opinion paragraph and *modify* the *scope* and *opinion* paragraphs.
G. Either an adverse opinion or a disclaimer of opinion	N. Describe the circumstances within the *scope* paragraph without adding an explanatory paragraph.
	O. Describe the circumstances within the *opinion* paragraph without adding an explanatory paragraph.
	P. Describe the circumstances within the *scope* and *opinion* paragraphs without adding an explanatory paragraph.
	Q. Issue the *standard* auditor's report *without modification.*

IV. Reporting

A. Reporting Standards and Types of Reports

M92
Answer 2 (10 points)

ANSWER 2		List A							List B										
	Item	Types of Opinions (select one)							Report Modifications (select one)										
	61	A	B	C	D	E	●	G	H	I	J	K	●	M	N	O	P	Q
	62	A	●	C	D	E	F	G	H	●	J	K	L	M	N	O	P	Q
	63	A	●	C	D	E	F	G	H	I	J	K	L	M	N	O	P	●
	64	●	B	C	D	E	F	G	H	I	●	K	L	M	N	O	P	Q
	65	A	●	C	D	E	F	G	H	●	J	K	L	M	N	O	P	Q
	66	A	●	C	D	E	F	G	H	●	J	K	L	M	N	O	P	Q
	67	A	B	C	D	●	F	G	H	I	●	K	L	M	N	O	P	Q

ESSAYS — SELECTED QUESTIONS

I. Professional Responsibilities

[Number 5 of the May 1992 exam, the first question in this section, begins on the following page.]

M92
Number 5 (Estimated time — — 15 to 25 minutes)

The following Accounts Receivable — Confirmation Statistics working paper (indexed B-3) was prepared by an audit assistant during the calendar year 1991 audit of Lewis County Water Co., Inc., a continuing audit client. The engagement supervisor is reviewing the working papers.

Index	B-3

Lewis County Water Co., Inc.
ACCOUNTS RECEIVABLE — CONFIRMATION STATISTICS
12/31/91

	Accounts		*Dollars*	
	Number	*Percent*	*Amount*	*Percent*
Confirmation Requests Positives	54	2.7%	$ 260,000	13.0%
Negatives	140	7.0%	20,000	10.0%
Total sent	194	9.7%	280,000	23.0%
Accounts selected/client asked us not to confirm	6	0.3%		
Total selected for testing	200	10.0%		
Total accounts receivable at 12/31/91, confirm date	2,000	100.0%	$2,000,000√★	100.0%
RESULTS				
Replies received through 2/25/92				
Positives — no exception	44 C	2.2%	180,000	9.0%
Negatives — did not reply or replied "no exception"	120 C	6.0%	16,000	.8%
Total confirmed without exception	164	8.2%	196,000	9.8%
Differences reported and resolved, no adjustment				
Positives	6 Φ	.3%	30,000	1.5%
Negatives	12	.6%	2,000	.1%
Total	18 ‡	.9%	32,000	1.6%
Differences found to be potential adjustments				
Positives	2 CX	.1%	10,000	.5%
Negatives	8 CX	.4%	2,000	.1%
Total — .6% adjustment, immaterial	10	.5%	12,000	.6%
Accounts selected/client asked us not to confirm	6	.3%		

Tickmark Legend

√ Agreed to accounts receivable subsidiary ledger
★ Agreed to general ledger and lead schedule
Φ Includes one related party transaction
C Confirmed without exception, W/P B-4
CX Confirmed with exception, W/P B-5

Overall conclusion — The potential adjustment of $12,000 or .6% is below materiality threshold; therefore, the accounts receivable balance is fairly stated.

Required: Describe the deficiencies in the working paper that the engagement supervisor should discover. Assume that the accounts were selected for confirmation on the basis of a sample that was properly planned and documented on working paper B-2.

M91

Number 5 (Estimated time —— 15 to 25 minutes)

Green, CPA, is considering audit risk at the financial statement level in planning the audit of National Federal Bank (NFB) Company's financial statements for the year ended December 31, 1990. Audit risk at the financial statement level is influenced by the risk of material misstatements, which may be indicated by a combination of factors related to management, the industry, and the entity. In assessing such factors Green has gathered the following information concerning NFB's environment.

Company profile:

NFB is a federally-insured bank that has been consistently more profitable than the industry average by marketing mortgages on properties in a prosperous rural area, which has experienced considerable growth in recent years. NFB packages its mortgages and sells them to large mortgage investment trusts. Despite recent volatility of interest rates, NFB has been able to continue selling its mortgages as a source of new lendable funds.

NFB's board of directors is controlled by Smith, the majority stockholder, who also acts as the chief executive officer. Management at the bank's branch offices has authority for directing and controlling NFB's operations and is compensated based on branch profitability. The internal auditor reports directly to Harris, a minority shareholder, who also acts as chairman of the board's audit committee.

The accounting department has experienced little turnover in personnel during the five years Green has audited NFB. NFB's formula consistently underestimates the allowance for loan losses, but its controller has always been receptive to Green's suggestions to increase the allowance during each engagement.

Recent developments:

During 1990, NFB opened a branch office in a suburban town thirty miles from its principal place of business. Although this branch is not yet profitable due to competition from several well-established regional banks, management believes that the branch will be profitable by 1992.

Also, during 1990, NFB increased the efficiency of its accounting operations by installing a new, sophisticated computer system.

Required:

Based only on the information above, describe the factors that most likely would have an effect on the risk of material misstatements. Indicate whether each factor increases or decreases the risk. Use the format illustrated below.

Environmental factor	*Effect on risk of material misstatements*
Branch management has authority for directing and controlling operations.	Increase

N90

Number 2 (Estimated time —— 15 to 25 minutes)

Dodd, CPA, audited Adams Company's financial statements for the year ended December 31, 1989. On November 1, 1990, Adams notified Dodd that it was changing auditors and that Dodd's services were being terminated. On November 5, 1990, Adams invited Hall, CPA, to make a proposal for an engagement to audit its financial statements for the year ended December 31, 1990.

Required:

a. What procedures concerning Dodd should Hall perform before accepting the engagement?

b. What additional procedures should Hall consider performing during the planning phase of this audit (after acceptance of the engagement) that would **not** be performed during the audit of a continuing client?

N89

Number 4 (Estimated time — — 15 to 25 minutes)

The following long-term debt working paper (indexed K-1) was prepared by client personnel and audited by AA, an audit assistant, during the calendar year 1988 audit of American Widgets, Inc., a continuing audit client. The engagement supervisor is reviewing the working papers thoroughly.

Index	K-1	
	Initials	Date
Prepared By	AA	3/22/89
Approved By		

American Widgets, Inc.
WORKING PAPERS
December 31, 1988

	Lender	Interest Rate	Payment Terms	Collateral	Balance 12/31/87	1988 Borrowings	1988 Reductions	Balance 12/31/88	Interest Paid to	Accrued Interest Payable 12/31/88	Comments
Φ	First Commercial Bank	12%	Interest only on 25th of month, principal due in full 1/1/92; no prepayment penalty	Inventories	$ 50,000 ✓	$300,000 A 1/31/88	$100,000 +O 6/30/88	$ 250,000 CX	12/25/88	$2,500 NR	Dividend of $80,000 paid 9/2/88 (W/P N-3) violates a provision of the debt agreement, which thereby permits lender to demand immediate payment; lender has refused to waive this violation
Φ	Lender's Capital Corp.	Prime plus 1%	Interest only on last day of month, principal due in full 3/5/90	2nd Mortgage on Park St. Building	100,000 ✓	50,000 A 2/29/88	—	200,000 C	12/31/88	—	Prime rate was 8% to 9% during the year
Φ	Gigantic Building & Loan Assoc.	12%	$5,000 principal plus interest due on 5th of month, due in full 12/31/99	1st Mortgage on Park St. Building	720,000 ✓	—	60,000 ϴ	660,000 C	12/5/88	5,642 R	Reclassification entry for current portion proposed (See RJE-3)
Φ	J. Lott, majority stockholder	0%	Due in full 12/31/91	Unsecured	300,000 ✓	—	100,000 N 12/31/88	200,000 C	—	—	Borrowed additional $100,000 from J. Lott on 1/7/89
					$1,170,000 ✓ F	$350,000 F	$260,000 F	$1,310,000 T/B F		$8,142 T/B F	

Tickmark Legend

- F Readded, foots correctly
- C Confirmed without exception, W/P K-2
- CX Confirmed with exception, W/P K-3
- NR Does not recompute correctly
- A Agreed to loan agreement, validated bank deposit ticket, and board of directors authorization, W/P W-7
- ϴ Agreed to canceled checks and lender's monthly statements
- N Agreed to cash disbursements journal and canceled check dated 12/31/88, clearing 1/8/89
- T/B Traced to working trial balance
- ✓ Agreed to 12/31/87 working papers
- Φ Agreed interest rate, term, and collateral to copy of note and loan agreement
- +O Agreed to canceled check and board of directors' authorization, W/P W-7

Interest costs from long-term debt

Interest expense for year	$ 281,333	T/B
Average loan balance outstanding	$1,406,667	R

Five year maturities (for disclosure purposes)

Year end	12/31/89	$ 60,000
	12/31/90	260,000
	12/31/91	260,000
	12/31/92	310,000
	12/31/93	60,000
	Thereafter	360,000
		$1,310,000 F

Overall conclusions

Long-term debt, accrued interest payable, and interest expense are correct and complete at 12/31/88

Required: Identify the deficiencies in the working paper that the engagement supervisor should discover.

M89
Number 5 (Estimated time —— 15 to 25 minutes)

Reed, CPA, accepted an engagement to audit the financial statements of Smith Company. Reed's discussions with Smith's new management and the predecessor auditor indicated the possibility that Smith's financial statements may be misstated due to the possible occurrence of errors, irregularities, and illegal acts.

Required:
a. Identify and describe Reed's responsibilities to detect Smith's errors and irregularities. Do **not** identify specific audit procedures.

b. Identify and describe Reed's responsibilities to report Smith's errors and irregularities.

c. Describe Reed's responsibilities to detect Smith's material illegal acts. Do **not** identify specific audit procedures.

d. Describe Reed's additional responsibilities to report on errors, irregularities, and illegal acts if this audit were one to which the requirements of *Government Auditing Standards* apply.

M88
Number 2 (Estimated time —— 15 to 25 minutes)

An accountant is sometimes called on by clients to report on or assemble prospective financial statements for use by third parties.

Required:
a. 1. Identify the types of engagements that an accountant may perform under these circumstances.
2. Explain the difference between "general use" of and "limited use" of prospective financial statements.
3. Explain what types of prospective financial statements are appropriate for "general use" and what types are appropriate for "limited use."

II. Internal Control

B. Consideration of the Internal Control Structure

N91
Number 3 (Estimated time —— 15 to 25 minutes)

Smith, CPA, has been engaged to audit the financial statements of Reed, Inc., a publicly held retailing company. Before assessing control risk Smith is required to obtain an understanding of Reed's control environment.

Required:
a. Identify additional control environment factors (excluding the factor illustrated in the example below) that establish, enhance, or mitigate the effectiveness of specific policies and procedures.

b. For the control environment factors identified in **a**, describe the components that could be of interest to the auditor.

Use the following format:

Management Philosophy and Operating Style

Management philosophy and operating style characteristics may include the following: management's approach to taking and monitoring business risks; management's attitudes and actions toward financial reporting; and management's emphasis on meeting budget, profit, and other financial and operating goals.

N90
Number 3 (Estimated time —— 15 to 25 minutes)

An auditor is required to obtain a sufficient understanding of each of the elements of an entity's internal control structure to plan the audit of the entity's financial statements and to assess control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

Required:
a. Identify the elements of an entity's internal control structure.

b. For what purposes should an auditor's understanding of the internal control structure elements be used in planning an audit?

c. Explain the reasons why an auditor may assess control risk at the maximum level for one or more assertions embodied in an account balance.

d. What must an auditor do to support assessing control risk at less than the maximum level when the auditor has determined that controls have been placed in operation?

C. Cycles

M92

Number 3 (Estimated time —— 15 to 25 minutes)

Harris, CPA, has accepted an engagement to audit the financial statements of Grant Manufacturing Co., a new client. Grant has an adequate control environment and a reasonable segregation of duties. Harris is about to assess control risk for the assertions related to Grant's property and equipment.

Required:

Describe the key internal control structure policies and procedures related to Grant's property, equipment, and related transactions (additions, transfers, major maintenance and repairs, retirements, and dispositions) that Harris may consider in assessing control risk.

M91

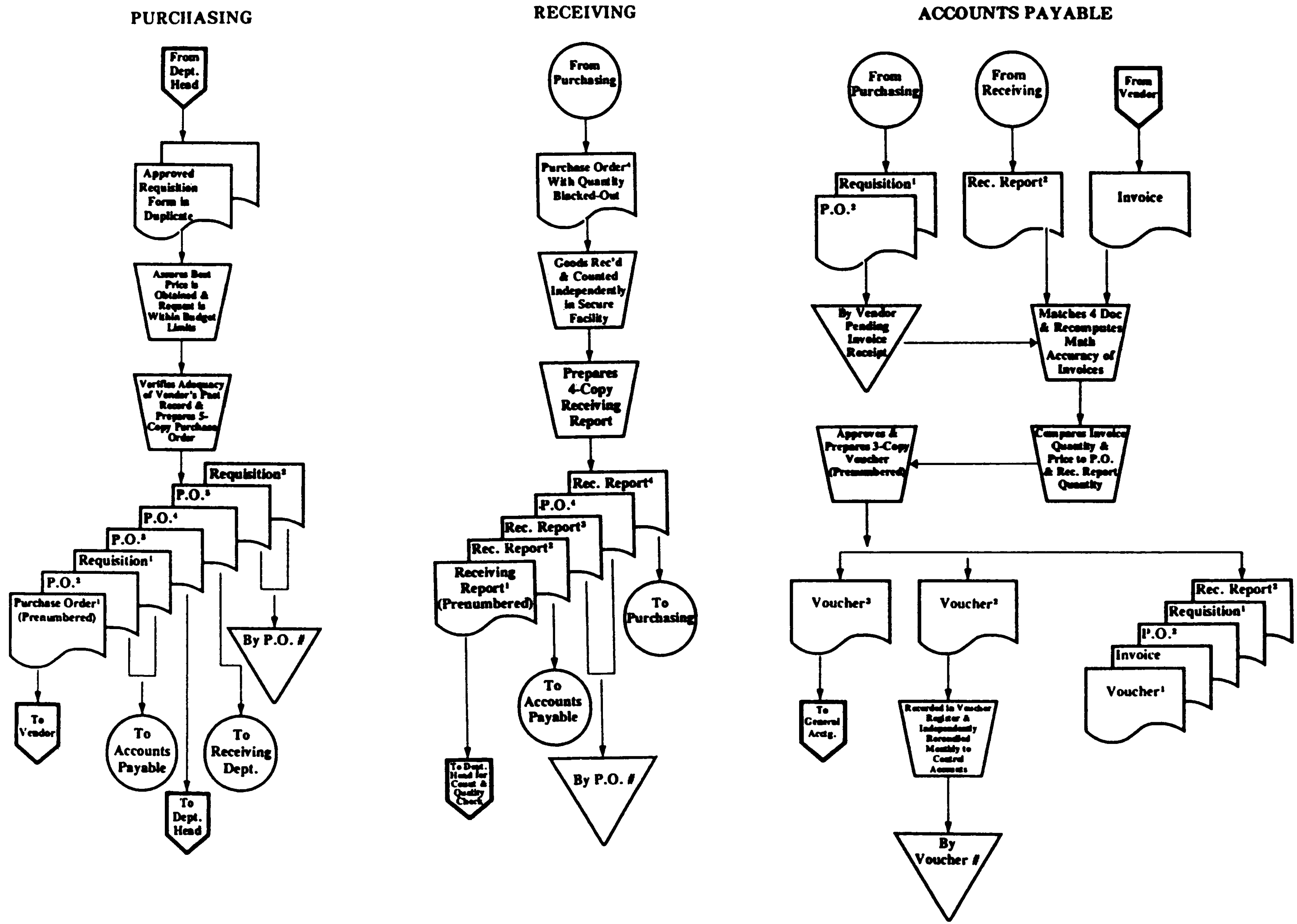
Number 4 (Estimated time —— 15 to 25 minutes)

The flowchart on the following page depicts the activities relating to the purchasing, receiving, and accounts payable departments of Model Company, Inc.

Required:

Based only on the flowchart, describe the internal control procedures (strengths) that most likely would provide reasonable assurance that specific internal control objectives for the financial statement assertions regarding purchases and accounts payable will be achieved. Do **not** describe weaknesses in the internal control structure.

M91
Number 4 (cont.)



N89

Number 5 (Estimated time —— 15 to 25 minutes)

A CPA's audit working papers include the narrative description below of the cash receipts and billing portions of the internal control structure of Parktown Medical Center, Inc. Parktown is a small health care provider that is owned by a publicly held corporation. It employs seven salaried physicians, ten nurses, three support staff in a common laboratory, and three clerical workers. The clerical workers perform such tasks as reception, correspondence, cash receipts, billing, and appointment scheduling and are adequately bonded. They are referred to in the narrative as "office manager," "clerk #1," and "clerk #2."

NARRATIVE

Most patients pay for services by cash or check at the time services are rendered. Credit is not approved by the clerical staff. The physician who is to perform the respective services approves credit based on an interview. When credit is approved, the physician files a memo with the billing clerk (clerk #2) to set up the receivable from data generated by the physician.

The servicing physician prepares a charge slip that is given to clerk #1 for pricing and preparation of the patient's bill. Clerk #1 transmits a copy of the bill to clerk #2 for preparation of the revenue summary and for posting in the accounts receivable subsidiary ledger.

The cash receipts functions are performed by clerk #1, who receives cash and checks directly from patients and gives each patient a prenumbered cash receipt. Clerk #1 opens the mail and immediately stamps all checks "for deposit only" and lists cash and checks for deposit. The cash and checks are deposited daily by the office manager. The list of cash and checks together with the related remittance advices are forwarded by clerk #1 to clerk #2. Clerk #1 also serves as receptionist and performs general correspondence duties.

Clerk #2 prepares and sends monthly statements to patients with unpaid balances. Clerk #2 also prepares the cash receipts journal and is responsible for the accounts receivable subsidiary ledger. No other clerical employee is permitted access to the accounts receivable subsidiary ledger. Uncollectible accounts are written off by clerk #2 only after the physician who performed the respective services believes the account to be uncollectible and communicates the write-off approval to the office manager. The office manager then issues a write-off memo that clerk #2 processes.

The office manager supervises the clerks, issues write-off memos, schedules appointments for the doctors, makes bank deposits, reconciles bank statements, and performs general correspondence duties.

Additional services are performed monthly by a local accountant who posts summaries prepared by the clerks to the general ledger, prepares income statements, and files the appropriate payroll forms and tax returns. The accountant reports directly to the parent corporation.

Required:

Based only on the information in the narrative, describe the reportable conditions and one resulting misstatement that could occur and not be prevented or detected by Parktown's internal control structure concerning the cash receipts and billing function. Do **not** describe how to correct the reportable conditions and potential misstatements. Use the format illustrated below.

Reportable condition	*Potential misstatement*
There is no control to verify that fees are recorded and billed at authorized rates and terms.	Accounts receivable could be overstated and uncollectible accounts understated because of the lack of controls.

M89

Number 3 (Estimated time —— 15 to 25 minutes)

Taylor, CPA, has been engaged to audit the financial statements of Johnsons Coat Outlet, Inc., a medium-sized mail-order retail store that sells a wide variety of coats to the public.

Required:

Prepare the "Shipments" segment of Taylor's internal control questionnaire. Each question should elicit either a yes or no response.

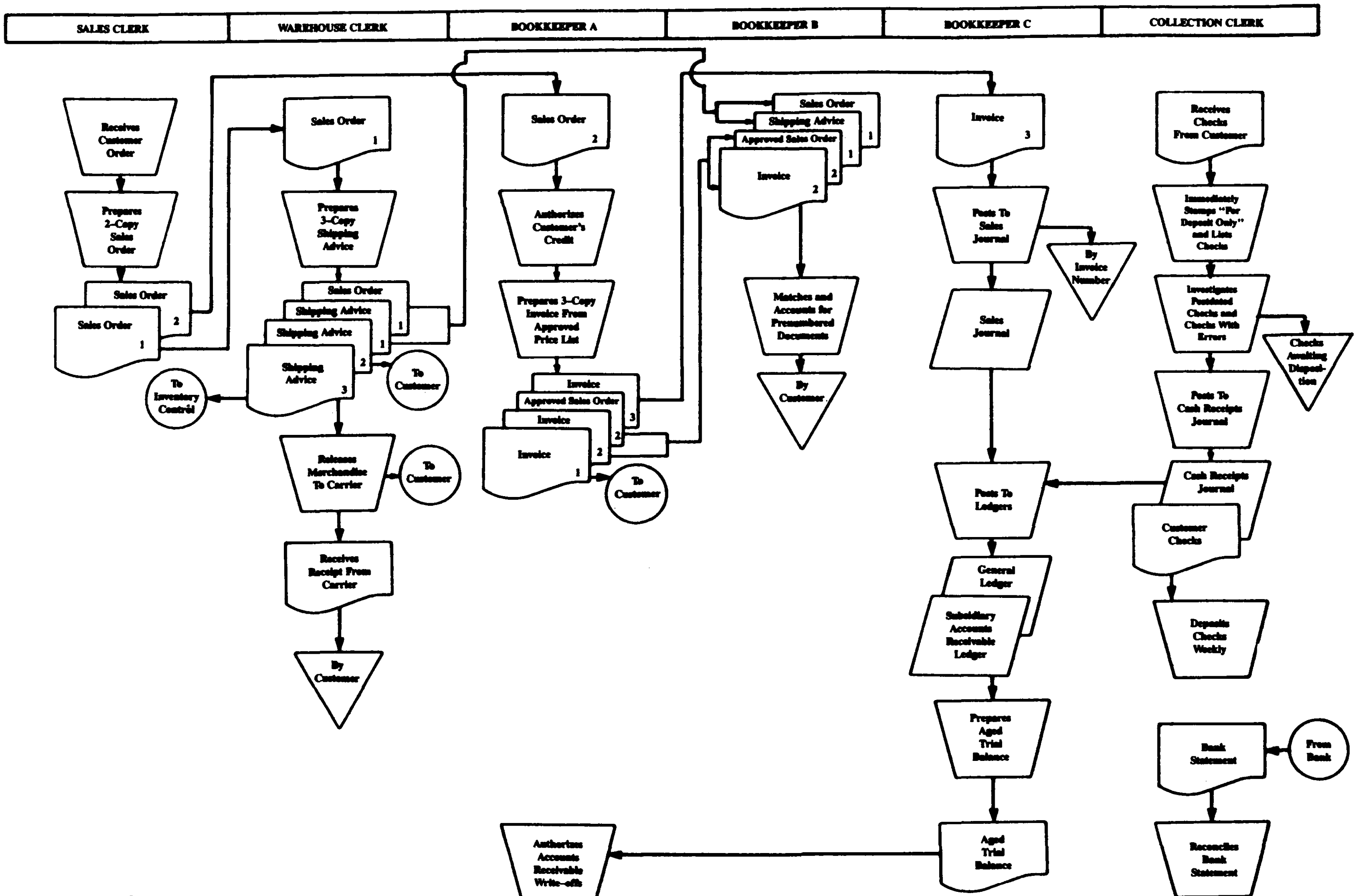
Do **not** prepare questions relating to the cash receipts, sales returns and allowances, billing, inventory control, or other segments.

Use the following format:

Question	Yes	No

M88 Number 4 (Estimated time — — 15 to 25 minutes)

The following flowchart depicts the activities relating to the sales, shipping, billing, and collecting processes used by Newton Hardware, Inc.



Required:
Identify the weaknesses in the system of internal accounting control relating to the activities of a) the warehouse clerk, b) bookkeeper A, and c) the collection clerk. Do **not** identify weaknesses relating to the sales clerk or bookkeepers B and C. Do **not** discuss recommendations concerning the correction of these weaknesses.

D. Other Considerations

N91
Number 5 (Estimated time —— 15 to 25 minutes)

Baker, CPA, was engaged to audit Mill Company's financial statements for the year ended September 30, 1991. After obtaining an understanding of Mill's internal control structure, Baker decided to obtain evidential matter about the effectiveness of both the design and operation of the policies and procedures that may support a low assessed level of control risk concerning Mill's shipping and billing functions. During the prior years' audits Baker used nonstatistical sampling, but for the current year Baker used a statistical sample in the tests of controls to eliminate the need for judgment.

Baker wanted to assess control risk at a low level, so a tolerable rate of deviation or acceptable upper precision limit (UPL) of 20% was established. To estimate the population deviation rate and the achieved UPL, Baker decided to apply a discovery sampling technique of attribute sampling that would use a population expected error rate of 3% for the 8,000 shipping documents, and decided to defer consideration of allowable risk of assessing control risk too low (risk of overreliance) until evaluating the sample results. Baker used the tolerable rate, the population size, and the expected population error rate to determine that a sample size of 80 would be sufficient. When it was subsequently determined that the actual population was about 10,000 shipping documents, Baker increased the sample size to 100.

Baker's objective was to ascertain whether Mill's shipments had been properly billed. Baker took a sample of 100 invoices by selecting the first 25 invoices from the first month of each quarter. Baker then compared the invoices to the corresponding prenumbered shipping documents.

When Baker tested the sample, eight errors were discovered. Additionally, one shipment that should have been billed at $10,443 was actually billed at $10,434. Baker considered this $9 to be immaterial and did not count it as an error.

In evaluating the sample results Baker made the initial determination that a reliability level of 95% (risk of assessing control risk too low 5%) was desired and, using the appropriate statistical sampling table, determined that for eight observed deviations from a sample size of 100, the achieved UPL was 14%. Baker then calculated the allowance for sampling risk to be 5%, the difference between the actual sample deviation rate (8%) and the expected error rate (3%). Baker reasoned that the actual sample deviation rate (8%) plus the allowance for sampling risk (5%) was less than the achieved UPL (14%); therefore, the sample supported a low level of control risk.

Required:

Describe each incorrect assumption, statement, and inappropriate application of attribute sampling in Baker's procedures.

M90
Number 3 (Estimated time —— 15 to 25 minutes)

During the course of an audit made in accordance with generally accepted auditing standards, an auditor may become aware of matters relating to the client's internal control structure that may be of interest to the client's audit committee or to individuals with an equivalent level of authority and responsibility, such as the board of directors, the board of trustees, or the owner in an owner-managed enterprise.

Required:

a. What are meant by the terms "reportable conditions" and "material weaknesses"?

b. What are an auditor's responsibilities in identifying and reporting these matters?

N88
Number 3 (Estimated time —— 15 to 25 minutes)

Sampling for attributes is often used to allow an auditor to reach a conclusion concerning a rate of occurrence in a population. A common use in auditing is to test the rate of deviation from a prescribed internal accounting control procedure to determine whether planned reliance on that control is appropriate.

Required:

a. When an auditor samples for attributes, identify the factors that should influence the auditor's judgment concerning the determination of

1. Acceptable level of risk of overreliance,
2. Tolerable deviation rate, and
3. Expected population deviation rate.

b. State the effect on sample size of an increase in each of the following factors, assuming all other factors are held constant:

1. Acceptable level of risk of overreliance,
2. Tolerable deviation rate, and
3. Expected population deviation rate.

c. Evaluate the sample results of a test for attributes if authorizations are found to be missing on 7 check requests out of a sample of 100 tested. The population consists of 2500 check requests, the tolerable deviation rate is 8%, and the acceptable level of risk of overreliance is low.

d. How may the use of statistical sampling assist the auditor in evaluating the sample results described in **c**, above?

III. Evidence and Procedures

A. Audit Evidence

N91
Number 4 (Estimated time —— 15 to 25 minutes)

Larkin, CPA, has been engaged to audit the financial statements of Vernon Distributors, Inc., a continuing audit client, for the year ended September 30, 1991. After obtaining an understanding of Vernon's internal control structure, Larkin assessed control risk at the maximum level for all financial statement assertions concerning investments. Larkin determined that Vernon is unable to exercise significant influence over any investee and none are related parties.

Larkin obtained from Vernon detailed analyses of its investments in domestic securities showing:

- The classification between current and noncurrent portfolios;
- A description of each security, including the interest rate and maturity date of bonds and par value and dividend rate on stocks;
- A notation of the location of each security, either in the Treasurer's safe or held by an independent custodian;
- The number of shares of stock or face amount of bonds held at the beginning and end of the year;
- The beginning and ending balances at cost and at market, and the unamortized premium or discount on bonds;
- Additions to and sales from the portfolios for the year, including date, number of shares, face amount of bonds, cost, proceeds, and realized gain or loss;
- Valuation allowances at the beginning and end of the year and changes therein;
- Accrued investment income for each investment at the beginning and end of the year, and income earned and collected during the year.

Larkin then prepared the following partial audit program of substantive auditing procedures:

1. Foot and crossfoot the analyses.
2. Trace the ending totals to the general ledger and financial statements.
3. Trace the beginning balances to the prior year's working papers.
4. Obtain positive confirmation as of the balance sheet date of the investments held by any independent custodian.
5. Determine that income from investments has been properly recorded as accrued or collected by reference to published sources, by computation, and by tracing to recorded amounts.
6. For investments in nonpublic entities, compare carrying value to information in the most recently available audited financial statements.
7. Determine that all transfers between the current and noncurrent portfolios have been properly authorized and recorded.
8. Determine that any other-than-temporary decline in the price of an investment has been properly recorded.

Required:

a. Identify the primary financial statement assertion relative to investments that would be addressed by each of the procedures #4 through #8 and describe the primary audit objective of performing that procedure. Use the format illustrated below.

Primary Assertion	*Objective*

M90
Number 5 (Estimated time —— 15 to 25 minutes)

Kent, CPA, is engaged in the audit of Davidson Corp.'s financial statements for the year ended December 31, 1989. Kent is about to commence auditing Davidson's employee pension expense, but Kent's preliminary inquiries concerning Davidson's defined benefit pension plan lead Kent to believe that some of the actuarial computations and assumptions are so complex that they are beyond the competence ordinarily required of an auditor. Kent is considering engaging Park, an actuary, to assist with this portion of the audit.

Required:

a. What are the factors Kent should consider in the process of selecting Park?

b. What are the matters that should be understood among Kent, Park, and Davidson's management as to the nature of the work to be performed by Park?

c. May Kent refer to Park in the auditor's report if Kent decides to issue an unqualified opinion? Why?

d. May Kent refer to Park in the auditor's report if Kent decides to issue other than an unqualified opinion as a result of Park's findings? Why?

N89
Number 3 (Estimated time —— 15 to 25 minutes)

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. They range from simple comparisons to the use of complex models involving many relationships and elements of data. They involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditors.

Required:
a. Describe the broad purposes of analytical procedures.

b. Identify the sources of information from which an auditor develops expectations.

c. Describe the factors that influence an auditor's consideration of the reliability of data for purposes of achieving audit objectives.

N88
Number 5 (Estimated time —— 15 to 25 minutes)

The purpose of all auditing procedures is to gather sufficient competent evidence for an auditor to form an opinion regarding the financial statements taken as a whole.

Required:
a. In addition to the example below, identify and describe five means or techniques of gathering audit evidence used to evaluate a client's inventory balance.

Technique	*Description*
Observation	An auditor watches the performance of some function, such as a client's annual inventory count.

b. Identify the five general assertions regarding a client's inventory balance and describe one **different** substantive auditing procedure for each assertion. Use the format illustrated below.

Assertion	*Substantive Auditing Procedure*

B. Specific Audit Objectives and Procedures

N91
Number 4 (Estimated time —— 15 to 25 minutes)

Larkin, CPA, has been engaged to audit the financial statements of Vernon Distributors, Inc., a continuing audit client, for the year ended September 30, 1991. After obtaining an understanding of Vernon's internal control structure, Larkin assessed control risk at the maximum level for all financial statement assertions concerning investments. Larkin determined that Vernon is unable to exercise significant influence over any investee and none are related parties.

Larkin obtained from Vernon detailed analyses of its investments in domestic securities showing:

- The classification between current and noncurrent portfolios;
- A description of each security, including the interest rate and maturity date of bonds and par value and dividend rate on stocks;
- A notation of the location of each security, either in the Treasurer's safe or held by an independent custodian;
- The number of shares of stock or face amount of bonds held at the beginning and end of the year;
- The beginning and ending balances at cost and at market, and the unamortized premium or discount on bonds;
- Additions to and sales from the portfolios for the year, including date, number of shares, face amount of bonds, cost, proceeds, and realized gain or loss;
- Valuation allowances at the beginning and end of the year and changes therein;
- Accrued investment income for each investment at the beginning and end of the year, and income earned and collected during the year.

Larkin then prepared the following partial audit program of substantive auditing procedures:

1. Foot and crossfoot the analyses.
2. Trace the ending totals to the general ledger and financial statements.
3. Trace the beginning balances to the prior year's working papers.
4. Obtain positive confirmation as of the balance sheet date of the investments held by any independent custodian.

5. Determine that income from investments has been properly recorded as accrued or collected by reference to published sources, by computation, and by tracing to recorded amounts.

6. For investments in nonpublic entities, compare carrying value to information in the most recently available audited financial statements.

7. Determine that all transfers between the current and noncurrent portfolios have been properly authorized and recorded.

8. Determine that any other-than-temporary decline in the price of an investment has been properly recorded.

Required:

b. Describe three additional substantive auditing procedures Larkin should consider in auditing Vernon's investments.

M91

Number 3 (Estimated time —— 15 to 25 minutes)

Taylor, CPA, has been engaged to audit the financial statements of Palmer Co., a continuing audit client. Taylor is about to perform substantive audit procedures on Palmer's goodwill (excess of cost over the fair value of net assets purchased) that was acquired in prior years' business combinations. An industry slowdown has occurred recently and purchased operations have not met profit expectations.

During the planning process, Taylor determined that there is a high risk that material misstatements in the assertions related to goodwill could occur. Taylor obtained an understanding of the internal control structure and assessed control risk at the maximum level for the assertions related to goodwill.

Required:

a. Describe the substantive audit procedures Taylor should consider performing in auditing Palmer's goodwill. Do **not** discuss Palmer's internal control structure.

b. Describe the two significant assertions that Taylor would be most concerned with relative to Palmer's goodwill. Do **not** describe more than two.

N90

Number 4 (Estimated time —— 15 to 25 minutes)

Kane, CPA, is auditing Star Wholesaling Company's financial statements and is about to perform substantive audit procedures on Star's trade accounts payable balances. After obtaining an understanding of Star's internal control structure for accounts payable, Kane assessed control risk at near the maximum. Kane requested and received from Star a schedule of the trade accounts payable prepared using the trade accounts payable subsidiary ledger (voucher register).

Required:

Describe the substantive audit procedures Kane should apply to Star's trade accounts payable balances. Do **not** include procedures that would be applied only in the audit of related party payables, amounts withheld from employees, and accrued expenses such as pensions and interest.

N89

Number 2 (Estimated time —— 15 to 25 minutes)

Bell, CPA, was engaged to audit the financial statements of Kent Company, a continuing audit client. Bell is about to audit Kent's payroll transactions. Kent uses an in-house payroll department to compute payroll data, and prepare and distribute payroll checks.

During the planning process, Bell determined that the inherent risk of overstatement of payroll expense is high. In addition, Bell obtained an understanding of the internal control structure and assessed control risk at the maximum level for payroll-related assertions.

Required:

Describe the audit procedures Bell should consider performing in the audit of Kent's payroll transactions to address the risk of overstatement. Do **not** discuss Kent's internal control structure.

M89

Number 4 (Estimated time —— 15 to 25 minutes)

Edwards, CPA, is engaged to audit the financial statements of Matthews Wholesaling for the year ended December 31, 1988. Edwards obtained and documented an understanding of the internal control structure relating to the accounts receivable and assessed control risk relating to accounts receivable at the maximum level. Edwards requested and obtained from Matthews an aged accounts receivable schedule listing the total amount owed by each customer as of December 31, 1988, and sent positive confirmation requests to a sample of the customers.

Required:

What additional substantive audit procedures should Edwards consider applying in auditing the accounts receivable?

M88

Number 3 (Estimated time —— 15 to 25 minutes)

Young, CPA, is considering the procedures to be applied concerning a client's loss contingencies relating to litigation, claims, and assessments.

Required:

What substantive audit procedures should Young apply when testing for loss contingencies relating to litigation, claims, and assessments?

C. Other Specific Audit Topics

M92
Number 4 (Estimated time —— 15 to 25 minutes)

Brown, CPA, is auditing the financial statements of Big Z Wholesaling, Inc., a continuing audit client, for the year ended January 31, 1992. On January 5, 1992, Brown observed the tagging and counting of Big Z's physical inventory and made appropriate test counts. These test counts have been recorded on a computer file. As in prior years, Big Z gave Brown two computer files. One file represents the perpetual inventory (FIFO) records for the year ended January 31, 1992. The other file represents the January 5 physical inventory count.

Assume:

- Brown issued an unqualified opinion on the prior year's financial statements.
- All inventory is purchased for resale and located in a single warehouse.
- Brown has appropriate computerized audit software.
- The perpetual inventory file contains the following information in item number sequence:
    - Beginning balances at February 1, 1991: Item number, item description, total quantity, and prices.
    - For each item purchased during the year: Date received, receiving report number, vendor, item number, item description, quantity, and total dollar amount.
    - For each item sold during the year: Date shipped, invoice number, item number, item description, quantity shipped, and dollar amount of the cost removed from inventory.
    - For each item adjusted for physical inventory count differences: Date, item number, item description, quantity, and dollar amount.
- The physical inventory file contains the following information in item number sequence: Tag number, item number, item description, and count quantity.

Required:
Describe the substantive auditing procedures Brown may consider performing with computerized audit software using Big Z's two computer files and Brown's computer file of test counts. The substantive auditing procedures described may indicate the reports to be printed out for Brown's follow-up by subsequent application of manual procedures. Do **not** describe subsequent manual auditing procedures.

Group the procedures by those using a) the perpetual inventory file and b) the physical inventory and test count files.

M90
Number 4 (Estimated time —— 15 to 25 minutes)

Green, CPA, is auditing the financial statements of Taylor Corporation for the year ended December 31, 1989. Green plans to complete the field work and sign the auditor's report about May 10, 1990. Green is concerned about events and transactions occurring after December 31, 1989 that may affect the 1989 financial statements.

Required:
a. What are the general types of subsequent events that require Green's consideration and evaluation?

b. What are the auditing procedures Green should consider performing to gather evidence concerning subsequent events?

N88
Number 2 (Estimated time —— 15 to 25 minutes)

Temple, CPA, is auditing the financial statements of Ford Lumber Yards, Inc., a privately-held corporation with 300 employees and five stockholders, three of whom are active in management. Ford has been in business for many years, but has never had its financial statements audited. Temple suspects that the substance of some of Ford's business transactions differ from their form because of the pervasiveness of related party relationships and transactions in the local building supplies industry.

Required:
Describe the audit procedures Temple should apply to identify related party relationships and transactions.

IV. Reporting

A. Reporting Standards and Types of Reports

N91
Number 2 (Estimated time —— 15 to 25 minutes)

Toxic Waste Disposal Co., Inc.(TWD) is a not-for-profit organization that receives grants and fees from various state and municipal governments as well as grants from several federal government agencies.

TWD engaged Hall & Hall, CPAs, to audit its financial statements for the year ended July 31, 1991, in accordance with *Government Auditing Standards.* Accordingly, the auditors' reports are to be submitted by TWD to the granting government agencies, which make the reports available for public inspection.

The auditors' separate report on compliance with laws and regulations that was drafted by a staff accountant of Hall & Hall at the completion of the engagement contained the statements below. It was submitted to the engagement partner who reviewed matters thoroughly and properly concluded that no material instances of noncompliance were identified.

1. A statement that the audit was conducted in accordance with generally accepted auditing standards and with *Government Auditing Standards* issued by the Comptroller General of the United States.

2. A statement that the auditors' procedures included tests of compliance.

3. A statement that the standards require the auditors to plan and to perform the audit to detect all instances of noncompliance with applicable laws and regulations.

4. A statement that management is responsible for compliance with laws, regulations, contracts, and grants.

5. A statement that the auditors' objective was to provide an opinion on compliance with the provisions of laws and regulations equivalent to that to be expressed on the financial statements.

6. A statement of positive assurance that the results of the tests indicate that, with respect to the items tested, the entity complied, in all material respects, with the provisions of laws, regulations, contracts, and grants.

7. A statement of negative assurance that, with respect to items tested, nothing came to the auditors' attention that caused the auditors to believe that the entity had not complied, in all material respects, with the provisions of laws, regulations, contracts, and grants.

8. A statement that the report is intended only for the information of the specific legislative or regulatory bodies, and that this restriction is intended to limit the distribution of the report.

Required:
For each of the above statements indicate whether each is an appropriate or inappropriate element within the report on compliance with laws and regulations. If a statement is **not** appropriate, explain why.

M91
Number 2 (Estimated time —— 15 to 25 minutes)

The auditors' report below was drafted by a staff accountant of Baker and Baker, CPAs, at the completion of the audit of the comparative financial statements of Ocean Shore Partnership for the years ended December 31, 1990 and 1989. Ocean Shore prepares its financial statements on the income tax basis of accounting. The report was submitted to the engagement partner who reviewed matters thoroughly and properly concluded that an unqualified opinion should be expressed.

<u>Auditor's Report</u>

We have audited the accompanying statements of assets, liabilities, and capital—income tax basis of Ocean Shore Partnership as of December 31, 1990 and 1989, and the related statements of revenue and expenses—income tax basis and changes in partners' capital accounts—income tax basis for the years then ended.

We conducted our audits in accordance with standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used as well as evaluating the overall financial statement presentation.

As described in Note A, these financial statements were prepared on the basis of accounting the Partnership uses for income tax purposes. Accordingly, these financial statements are not designed for those who do not have access to the Partnership's tax returns.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of Ocean Shore Partnership as of December 31, 1990 and 1989, and its revenue and expenses and changes in partners' capital accounts for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Baker and Baker, CPAs
April 3, 1991

Required:
Identify the deficiencies contained in the auditors' report as drafted by the staff accountant. Group the deficiencies by paragraph, where applicable. Do **not** redraft the report.

N90
Number 5 (Estimated time —— 15 to 25 minutes)

The following report was drafted on October 25, 1990, by Major, CPA, at the completion of the engagement to compile the financial statements of Ajax Company for the year ended September 30, 1990. Ajax is a nonpublic entity in which Major's child has a material direct financial interest. Ajax decided to omit substantially all of the disclosures required by generally accepted accounting principles because the financial statements will be for management's use only. The statement of cash flows was also omitted because management does not believe it to be a useful financial statement.

To the Board of Directors of Ajax Company:

I have compiled the accompanying financial statements of Ajax Company as of September 30, 1990, and for the year then ended. I planned and performed the compilation to obtain limited assurance about whether the financial statements are free of material misstatements.

A compilation is limited to presenting information in the form of financial statements. It is substantially less in scope than an audit in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. I have not audited the accompanying financial statements and, accordingly, do not express any opinion on them.

Management has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's financial position, results of operations, and changes in financial position.

I am not independent with respect to Ajax Company. This lack of independence is due to my child's ownership of a material direct financial interest in Ajax Company.

This report is intended solely for the information and use of the Board of Directors and management of Ajax Company and should not be used for any other purpose.

Major, CPA

Required:
Identify the deficiencies contained in Major's report on the compiled financial statements. Group the deficiencies by paragraph where applicable. Do **not** redraft the report.

M90
Number 2 (Estimated time —— 15 to 25 minutes)

For the year ended December 31, 1988, Friday & Co., CPAs (Friday), audited the financial statements of Johnson Company and expressed an unqualified opinion on the balance sheet only. Friday did not observe the taking of the physical inventory as of December 31, 1987, because that date was prior to their appointment as auditors. Friday was unable to satisfy themselves regarding inventory by means of other auditing procedures, so they did not express an opinion on the other basic financial statements that year.

For the year ended December 31, 1989, Friday expressed an unqualified opinion on all the basic financial statements and satisfied themselves as to the consistent application of generally accepted accounting principles. The field work was completed on March 11, 1990; the partner-in-charge reviewed the working papers and signed the auditor's report on March 18, 1990. The report on the comparative financial statements for 1989 and 1988 was delivered to Johnson on March 21, 1990.

Required:
Prepare Friday's auditor's report that was submitted to Johnson's board of directors on the 1989 and 1988 comparative financial statements.

M89
Number 2 (Estimated time —— 15 to 25 minutes)

The auditors' report below was drafted by a staff accountant of Turner & Turner, CPAs, at the completion of the audit of the financial statements of Lyon Computers, Inc., for the year ended March 31, 1989. It was submitted to the engagement partner who reviewed matters thoroughly and properly concluded that Lyon's disclosures concerning its ability to continue as a going concern for a reasonable period of time were adequate. Early application of Statement on Auditing Standards No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* was chosen by Turner & Turner.

To the Board of Directors of Lyon Computers, Inc.:

We have audited the accompanying balance sheet of Lyon Computers, Inc. as of March 31, 1989, and the other related financial statements for the year then ended. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with standards that require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are in conformity with generally accepted accounting principles. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. We believe that management's plans in regards to these matters, which are also described in Note X, will permit the Company to continue as a going concern beyond a reasonable period of time. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the financial statements referred to above present fairly, in all material respects, the financial position of Lyon Computers, Inc., and the results of its operations and its cash flows in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Turner & Turner, CPAs
April 28, 1989

Required:

Identify the deficiencies contained in the auditor's report as drafted by the staff accountant. Group the deficiencies by paragraph. Do **not** redraft the report.

N88
Number 4 (Estimated time —— 15 to 25 minutes)

The following report on the basic financial statements was drafted by a staff assistant at the completion of the review engagement of GLM Company, a continuing client, for the year ended September 30, 1988. The 1987 basic financial statements for the year ended September 30, 1987, which were also reviewed, contained a departure from generally accepted accounting principles that was properly referred to in the 1987 review report dated October 26, 1987. The 1987 financial statements have been restated.

To the Board of Directors of GLM Company:

We have reviewed the accompanying balance sheets of GLM Company as of September 30, 1988 and 1987, and the related statements of income and retained earnings for the years then ended, in accordance with generally accepted auditing standards. Our review included such tests of the accounting records as we considered necessary in the circumstances.

A review consists principally of inquiries of company personnel. It is substantially less in scope than an audit, but more in scope than a compilation. Accordingly, we express only limited assurance on the accompanying financial statements.

Based on our reviews, with the exception of the matter described in the following paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles applied on a consistent basis.

In its 1987 financial statements the company stated its land at appraised values. However, as disclosed in note X, the company has restated its 1987 financial statements to reflect land at cost.

November 2, 1988

Required:

Identify the deficiencies in the draft of the proposed report on the comparative financial statements. Group the deficiencies by paragraph. Do **not** redraft the report.

M88
Number 2 (Estimated time —— 15 to 25 minutes)

An accountant is sometimes called on by clients to report on or assemble prospective financial statements for use by third parties.

Required:

b. Describe the contents of the accountant's standard report on a compilation of a financial projection.

I. Professional Responsibilities

M92
Answer 5 (10 points)

The working paper contains the following deficiencies:

The working paper was not initialed and dated by the audit assistant.

Negative confirmations not returned cannot be considered to be accounts "confirmed without exception."

The two positive confirmations that were sent but were unanswered are not accounted for.

There is no documentation of alternate procedures, possible scope limitation, or other working paper reference for the six accounts selected for confirmation that the client asked the auditor not to confirm.

The dollar amount and percent of the six accounts selected for confirmation that the client asked the auditor not to confirm is omitted from the "Dollars" columns for the "Total selected for testing."

The "Dollars—Percent" for "Confirmation Requests—Negatives" is incorrectly calculated at 10%.

There is no indication of follow-up or cross-referencing of the account confirmed—related party transaction.

The tickmark "‡" is used but is not explained in the tickmark legend.

There is no explanation or proposed disposition of the 10 differences aggregating $12,000.

The overall conclusion reached is not appropriate.

There is no notation that a projection from the sample to the population was made.

There is no reference to second requests.

Cross-referencing is incomplete, such as the 18 "Differences reported and resolved, no adjustment" and "Confirmation Requests" to confirmation control schedule.

M91
Answer 5 (10 points)

The factors most likely to have an effect on the risk of material misstatements and their resulting effect include the following:

Environmental factor	*Effect on risk of material misstatements*
Government regulation over the banking industry is extensive.	Decrease
NFB operates profitably in a growing prosperous area.	Decrease
Overall demand for the industry's product is high.	Decrease
Interest rates have been volatile recently.	Increase
The availability of funds for additional mortgages is promising.	Decrease
The principal shareholder is also the chief executive officer and controls the board of directors.	Increase
Branch management is compensated based on branch profitability.	Increase
The internal auditor reports directly to the chairman of the board's audit committee, a minority shareholder.	Decrease
The accounting department has experienced little turnover in personnel recently.	Decrease
NFB is a continuing audit client.	Decrease

Environmental factor	*Effect on risk of material misstatements*
Management fails to establish proper procedures to provide reasonable assurance of reliable accounting estimates.	Increase
Management has been receptive to Green's suggestions relating to accounting adjustments.	Decrease
NFB recently opened a new branch office that is not yet profitable.	Increase
NFB recently installed a new sophisticated computer system.	Increase

N90
Answer 2 (10 points)

a. The procedures Hall should perform before accepting the engagement include the following:

1. Hall should explain to Adams the need to make an inquiry of Dodd and should request permission to do so.

2. Hall should ask Adams to authorize Dodd to respond fully to Hall's inquiries.

3. If Adams refuses to permit Dodd to respond or limits Dodd's response, Hall should inquire as to the reasons and consider the implications in deciding whether to accept the engagement.

4. Hall should make specific and reasonable inquiries of Dodd regarding matters Hall believes will assist in determining whether to accept the engagement, including specific questions regarding

- Facts that might bear on the integrity of management;
- Disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters;
- Dodd's understanding as to the reasons for the change of auditors.

5. If Hall receives a limited response, Hall should consider its implications in deciding whether to accept the engagement.

b. The additional procedures Hall should consider performing during the planning phase of this audit that would not be performed during the audit of a continuing client may include the following:

1. Hall may apply appropriate auditing procedures to the account balances at the beginning of the audit period and, possibly, to transactions in prior periods.

2. Hall may make specific inquiries of Dodd regarding matters Hall believes may affect the conduct of the audit, such as

- Audit areas that have required an inordinate amount of time;
- Audit problems that arose from the condition of the accounting system and records.

3. Hall may request Adams to authorize Dodd to allow a review of Dodd's working papers.

4. Hall should document compliance with firm policy regarding acceptance of a new client.

5. Hall should start obtaining the documentation needed to create a permanent working paper file.

N89
Answer 4 (10 points)

The working paper contains the following deficiencies:

1. The subject matter of the working paper is not properly indicated in the title.
2. There is no indication of any follow-up on the identified error in the accrued interest payable computation.
3. There is no indication whether the confirmation exception was resolved.
4. The loan with the unwaived violation of a provision of the debt agreement is misclassified as long-term.
5. The liability activities of Lender's Capital Corp. and the working paper totals do not crossfoot.
6. There is no indication of cross-referencing of the stockholder loan to the related party transactions working papers.
7. There is no investigation of the payment on the stockholder loan that was reborrowed soon after year-end.
8. There is no consideration of the need to impute interest expense on the 0% stockholder loan.
9. There is no indication that the dates under "interest paid to" were audited.
10. There is no indication that the unusually high average interest rate ($281,333/$1,406,667 = 20%) was noted and investigated.
11. The working paper does not support the overall conclusions expressed.
12. The tickmark "R" is used but not explained in the tickmark legend.
13. There is no indication that the working paper was prepared by client personnel.

M89

Answer 5 (10 points)

a. To satisfy an auditor's responsibilities to detect Smith's errors and irregularities, Reed should

- Assess the risk that Smith's errors and irregularities may cause its financial statements to contain a material misstatement.
- Design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.
- Exercise due care in planning, performing, and evaluating the results of audit procedures, and the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected.

b. To satisfy an auditor's responsibilities to report Smith's errors and irregularities, Reed should

- Inform Smith's audit committee, or others having equivalent authority and responsibility, about material irregularities of which Reed becomes aware.
- Express a qualified or an adverse opinion on the financial statements if they are materially affected by an error or irregularity and are not revised.
- Disclaim or qualify an opinion on the financial statements and communicate the findings to the audit committee or the board of directors if the scope of the audit has been restricted concerning a possible irregularity.
- Consider notification of outside parties concerning irregularities in certain circumstances.

c. Reed's responsibilities to detect Smith's illegal acts that have a material and direct effect on Smith's financial statements are the same as that for errors and irregularities.

Reed's responsibilities to detect Smith's illegal acts that have a material and indirect effect on the financial statements are to be aware of the possibility that such illegal acts may have occurred. If specific information comes to Reed's attention that provides evidence concerning the existence of such possible illegal acts, Reed should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

d. In an audit to which GAO standards apply, Reed should additionally

- Determine that instances or apparent indications of illegal acts are reported to the funding agency or other specified agency.
- Express positive assurance on whether the items tested were in compliance with applicable laws and regulations.
- Express negative assurance that, except as otherwise noted, nothing came to Reed's attention that caused Reed to believe that the untested items were not in compliance with applicable laws and regulations.

M88

Answer 2

a. 1. An accountant who reports on or assembles prospective financial statements for use by third parties should perform any one of three engagements. The accountant may compile, examine, or apply agreed-upon procedures to the prospective financial statements.

2. "General use" of prospective financial statements refers to use of the statements by persons (creditors, stockholders, etc.) with whom the responsible party (management) is not negotiating directly. "Limited use" of prospective financial statements refers to the use of prospective financial statements by the responsible party alone or by the responsible party and third parties with whom the responsible party is negotiating directly.

3. Only a financial forecast is appropriate for general use, but any type of prospective financial statements (either a financial forecast or a financial projection) would normally be appropriate for limited use.

B. Consideration of the Internal Control Structure

N91
Answer 3 (10 points)

The control environment factors (excluding the factor illustrated in the example) that establish, enhance, or mitigate the effectiveness of specific policies and procedures, and their components are

Organizational Structure

An entity's organizational structure provides the overall framework for planning, directing, and controlling operations. An organizational structure includes consideration of the form and nature of an entity's organizational units, including the data processing organization, and related management functions and reporting relationships. In addition, the organizational structure should assign authority and responsibility within the entity in an appropriate manner.

Audit Committee/Board of Directors

An effective audit committee takes an active role in overseeing an entity's accounting and financial reporting policies and practices. The committee should assist the board of directors in fulfilling its fiduciary and accountability responsibilities and should help maintain a direct line of communication between the board and the entity's external and internal auditors.

Methods of Assigning Authority and Responsibility

These methods affect the understanding of reporting relationships and responsibilities established within the entity. Methods of assigning authority and responsibility include consideration of—

- Entity policy regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct.
- Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- Employee job descriptions delineating specific duties, reporting relationships, and constraints.
- Computer systems documentation indicating the procedures for authorizing transactions and approving system changes.

Internal Audit Function

The internal audit function is established within an entity to examine and evaluate the adequacy and effectiveness of other internal control structure policies and procedures. Establishing an effective internal audit function includes consideration of its authority and reporting relationships, the qualifications of its staff, and its resources.

Management Control Methods

These methods affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise overall company activities. Management control methods include consideration of—

- Establishing planning and reporting systems that set forth management's plans and the results of actual performance. Such systems may include business planning; budgeting, forecasting, and profit planning; and responsibility accounting.
- Establishing methods that identify the status of actual performance and exceptions from planned performance, as well as communicating them to the appropriate levels of management.
- Using such methods at appropriate management levels to investigate variances from expectations and to take appropriate and timely corrective action.
- Establishing and monitoring policies for developing and modifying accounting systems and control procedures, including the development, modification, and use of any related computer programs and data files.

Personnel Policies and Practices

These policies and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Personnel policies and practices include consideration of an entity's policies and procedures for hiring, training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

External Influences

These are influences established and exercised by parties outside an entity that affect an entity's operations and practices. They include monitoring and compliance requirements imposed by legislative and regulatory bodies, such as examinations by bank regulatory agencies. They also include review and follow-up by parties outside the entity concerning entity actions. External influences are ordinarily outside an entity's authority. Such influences, however, may heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations and may also prompt management to establish specific internal control structure policies or procedures.

N90
Answer 3 (10 points)

a. For purposes of an audit of financial statements, an entity's internal control structure consists of the three following elements:

- The control environment
- The accounting system
- Control procedures

b. In planning an audit, the knowledge obtained from an auditor's understanding of the elements of an entity's internal control structure should be used to:

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design substantive tests.

c. An auditor may assess control risk at the maximum level for some or all assertions because the auditor believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient.

d. To support assessing control risk at less than the maximum level, an auditor must determine whether the policies and procedures are suitably designed to prevent or detect material misstatements in specific financial statement assertions and obtain evidence that the policies and procedures are operating effectively.

C. Cycles

M92
Answer 3 (10 points)

The key internal control structure policies and procedures related to Grant's property, equipment, and related transactions that Harris may consider in assessing control risk include the following:

- Advance approval in accordance with management's criteria is required for property and equipment transactions.

- Approval authority for transactions above an established dollar value is required at a higher level, such as the board of directors.

- Property and equipment transactions are adequately documented.

- There are written policies covering capitalizing expenditures, classifying leases, and determining estimated useful lives, salvage values, and methods of depreciation and amortization.

- There are written policies covering retirement procedures that include serially numbered retirement work orders, stating reasons for retirement and bearing appropriate approvals.

- There are adequate policies and procedures to determine whether property and equipment are received and properly recorded, such as a system that matches purchase orders, receiving reports, and vendors' invoices.

- There are adequate procedures to determine whether dispositions of property and equipment are properly accounted for and proceeds, if any, are received in accordance with management's authorization.

- A property and equipment subsidiary ledger is maintained showing additions, retirements, and depreciation, and the ledger is periodically reconciled.

- Property and equipment is physically inspected and reconciled at reasonable intervals with independently maintained property and equipment records.

- An annual budget is prepared and monitored to forecast and control acquisitions and retirements of property and equipment.

- Reporting procedures assure prompt identification and analysis of variances between authorized expenditures and actual costs.

- Property and equipment is protected by adequate safeguards.

- Property and equipment is insured in accordance with management's authorization.

- Documents evidencing title and property rights are periodically compared with the detailed property records.

- The entity employs internal auditors to test whether the internal control structure policies and procedures are operating effectively.

M91
Answer 4 (10 points)

The internal control procedures that most likely would provide reasonable assurance that specific control objectives for the financial statement assertions regarding purchases and accounts payable will be achieved are

1. Proper authorization of requisitions by department head is required before purchase orders are prepared.
2. Purchasing department assures that requisitions are within budget limits before purchase orders are prepared.
3. The adequacy of each vendor's past record as a supplier is verified.

4. Secure facilities limit access to the goods during the receiving activity.
5. Receiving department makes a blind count of the goods received, independently of any other department.
6. The requisitioning department head independently verifies the quantity and quality of the goods received.
7. Requisitions, purchase orders, and receiving reports are matched with vendor invoices as to quantity and price.
8. Accounts payable department recomputes the mathematical accuracy of each invoice.
9. The voucher register is independently reconciled to the control accounts monthly.
10. All supporting documentation is required for payment and is made available to the treasurer.
11. The purchasing, receiving, and accounts payable functions are segregated.

N89

Answer 5 (10 points)

The reportable conditions and resulting misstatements, in addition to the example, that could occur and not be prevented or detected by Parktown's internal control structure concerning the cash receipts and billing functions include the following:

Reportable condition	*Potential misstatement*
The employees who perform services also are permitted to approve credit without an external credit check.	Uncollectible accounts expense could be understated and accounts receivable could be overstated because of the lack of an appropriate credit check.
There is no independent verification of the billing process.	Fees earned and accounts receivable may be understated because not all services performed might be reported for billing. or Fees earned and accounts receivable may be either overstated or understated because of the use of incorrect price or service data or because of mathematical errors.
The employees who approve credit also approve write-offs of uncollectible accounts.	Acccounts receivable could be understated and uncollectible accounts expense overstated because write-offs of accounts receivable could be approved for accounts that are, in fact, collectible. or Accounts receivable could be overstated and uncollectible accounts expense understated because write-offs of accounts receivable might not be initiated for accounts that are uncollectible.
Credit is not granted on the basis of established limits.	Uncollectible accounts expense could be either understated or overstated because the lack of established credit limits may make it more difficult to identify uncollectible amounts.
The employee who initially handles cash receipts also prepares billings.	Fees earned and cash receipts or accounts receivable could be understated because of omitted or inaccurate billing.
The employee who makes bank deposits also reconciles bank statements.	The cash balance per books may be overstated because not all cash is deposited.
Uncollectible accounts are not determined on the basis of established criteria.	Uncollectible accounts expense could be either understated or overstated because of the lack of established write-off criteria.

Reportable condition	*Potential misstatement*
Trial balances of the accounts receivable subsidiary ledger are not prepared independently of, or verified and reconciled to, the accounts receivable control account in the general ledger.	Any of fees earned, cash receipts, and uncollectible accounts expense could be either understated or overstated because of undetected differences between the subsidiary ledger and the general ledger. or Fees earned and cash receipts or accounts receivable could be understated because of failure to record billings, cash receipts, or write-offs accurately.

M89
Answer 3 (10 points)

JOHNSONS COAT OUTLET, INC.
Shipments
Internal Control Questionnaire

Question	*Yes*	*No*
1. Are shipping documents prepared from sales orders approved in accordance with management's authorization?		
2. Are shipping documents prenumbered?		
3. Are shipping documents periodically accounted for?		
4. Are shipping documents recorded in a register, log, or file?		
5. Are copies of shipping documents forwarded to the Billing department? Inventory control department?		
6. Do shipping documents include cross reference to sales orders; customer identity and address; description and quantities of goods shipped; date; and other details?		
7. Is the shipping function independent of Sales orders? Credit approval? Billing and accounts receivable? Cash receipts? Warehouse? Receiving? Inventory control?		
8. Is access to merchandise restricted and controlled within the shipping department?		
9. Are type and quantities of goods withdrawn and packed for shipping verified by independent counts?		
10. Are receipts from carriers obtained and filed?		

M88
Answer 4 (10 points)

The weaknesses in Newton Hardware's internal accounting controls include these:

Warehouse Clerk

- Initiates posting to inventory records by preparation of shipping advice.
- Releases merchandise to customers before proper approvals of customers' credit.
- Does not retain a copy of the shipping advice for comparison with receipt from carrier.

Bookkeeper A

- Authorizes customers' credit and prepares source documents for posting to customers' accounts.
- Prepares invoices without notice that the merchandise was actually shipped and the date it was shipped.
- Authorizes write-offs of customer accounts receivable and authorizes customers' credit.

Collection Clerk

- Receives directly and records customers' checks.
- Does not deliver checks excluded from the deposit to an employee independent of the bank deposit for review and disposition.
- Initiates posting of receipts to subsidiary accounts receivable ledger and has initial access to cash receipts.
- Does not deposit cash receipts promptly.
- Reconciles bank statement and has initial access to cash receipts.

D. Other Considerations

N91

Answer 5 (10 points)

1. Statistical sampling does not eliminate the need for professional judgment.

2. The tolerable rate of deviation or acceptable upper precision limit (UPL) is too high (20%) if Baker plans to assess control risk at a low level (substantial reliance).

3. Discovery sampling is not an appropriate sampling technique in this attribute sampling application.

4. The sampling technique employed is not discovery sampling.

5. The increase in the population size has little or no effect on determining sample size.

6. Baker failed to consider the allowable risk of assessing control risk too low (risk of overreliance) in determining the sample size.

7. The population from which the sample was chosen (invoices) was an incorrect population.

8. The sample selected was not randomly selected.

9. Baker failed to consider the difference of an immaterial amount to be an error.

10. The allowance for sampling risk was incorrectly calculated.

11. Baker's reasoning concerning the decision that the sample supported a low assessed level of control risk was erroneous.

M90

Answer 3 (10 points)

a. Reportable conditions are matters that come to an auditor's attention, which, in the auditor's judgment, should be communicated to the client's audit committee or its equivalent because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Material weaknesses are reportable conditions in which the design or operation of specific internal control structure elements do not reduce, to a relatively low level, the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

b. An auditor is required to identify reportable conditions that come to the auditor's attention in the normal course of an audit, but is not obligated to search for reportable conditions. The auditor uses judgment as to which matters are reportable conditions. Provided the audit committee has acknowledged its understanding and consideration of such deficiencies and the associated risks, the auditor may decide certain matters do not need to be reported unless, because of changes in management or the audit committee, or because of the passage of time, it is appropriate to do so.

Conditions noted by the auditor that are considered reportable should be reported, preferably in writing. If information is communicated orally, the auditor should document the communication. The report should state that the communication is intended solely for the information and use of the audit committee, management, and others within the organization.

The auditor may identify and communicate separately those reportable conditions the auditor considers to be material weaknesses, but may not state that no reportable conditions were noted during the audit. Reportable conditions may be communicated during the course of the audit rather than after the audit is concluded, depending on the relative significance of the matters noted and the urgency of corrective follow-up action.

N88

Answer 3 (10 points)

a. 1. In determining an acceptable level of risk of overreliance, an auditor should consider the importance of the control to be tested in determining the extent to which substantive tests will be restricted and the planned degree of reliance on that control.

2. In determining the tolerable deviation rate, an auditor should consider the planned degree of reliance on the control to be tested and how materially the financial statements would be affected if the control does not function properly. For example, how likely is the control to prevent or detect material errors?

3. In determining the expected population deviation rate, an auditor should consider the results of prior years' tests, the overall control environment, or utilize a preliminary sample.

b. 1. There is a decrease in sample size if the acceptable level of risk of overreliance is increased.

2. There is a decrease in sample size if the tolerable deviation rate is increased.

3. There is an increase in sample size if the population deviation rate is increased.

c. For a low risk of overreliance it is generally appropriate to reconsider the planned reliance as the calculated estimate of the population deviation rate identified in the sample (7%) approaches the tolerable deviation rate (8%). This is because there may be an unacceptably high sampling risk that these sample results could have occurred with an actual population deviation rate higher than the tolerable deviation rate.

d. If statistical sampling is used, an allowance for sampling risk can be calculated. If the calculated estimate of the population deviation rate plus the allowance for sampling risk is greater than the tolerable deviation rate, the sample results should be interpreted as not supporting the planned reliance on the control.

III. Evidence and Procedures

A. Audit Evidence

N91
Answer 4

a.

Primary Assertion	*Objective*
4. Existence or occurrence	To determine that the custodian holds the securities as identified in the confirmation.
5. Completeness	To determine that all income and related collections from the investments are properly recorded.
6. Valuation or allocation	To determine that the market or other value of the investments is fairly stated.
7. Presentation and disclosure	To determine that the financial statement presentation and disclosure of investments is in conformity with generally accepted accounting principles consistently applied.
8. Valuation or allocation	To determine that the market or other value of the investments is fairly stated and the loss is properly recognized and recorded.

M90
Answer 5 (10 points)

a. The factors Kent should consider in the process of selecting Park include

- Park's professional certification, license, or other recognition of Park's competence.
- Park's reputation and standing in the views of Park's peers and others familiar with Park's capability or performance.
- Park's relationship, if any, to Davidson Corporation.

b. The understanding among Kent, Park, and Davidson's management as to the nature of the work to be performed by Park should cover

- The objectives and scope of Park's work.
- Park's representations as to Park's relationship, if any, to Davidson.
- The methods or assumptions to be used.
- A comparison of the methods or assumptions to be used with those used in the preceding period.
- Park's understanding of Kent's corroborative use of Park's findings.
- The form and content of Park's report that would enable Kent to evaluate Park's findings.

c. Kent may not refer to Park in the auditor's report if Kent decides to issue an unqualified opinion. Such a reference might be misunderstood to be a qualification, a division of responsibility, or an inference that a more thorough audit was performed.

d. Kent may refer to Park in the auditor's report if Kent decides to issue other than an unqualified opinion as a result of Park's findings. Reference is permitted if it will facilitate an understanding of the reason for the modification.

N89
Answer 3 (10 points)

a. Analytical procedures are used for these broad purposes:

- To assist the auditor in planning the nature, timing, and extent of other auditing procedures.
- As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.
- As an overall review of the financial information in the final review stage of the audit.

b. An auditor's expectations are developed from the following sources of information:

- Financial information for comparable prior periods giving consideration to known changes.

- Anticipated results — for example, budgets, forecasts, and extrapolations.
- Relationships among elements of financial information within the period.
- Information regarding the industry in which the client operates.
- Relationships of financial information with relevant nonfinancial information.

c. The factors that influence an auditor's consideration of the reliability of data for purposes of achieving audit objectives are whether the

- Data were obtained from independent sources outside the entity or from sources within the entity.
- Sources within the entity were independent of those who are responsible for the amount being audited.
- Data were developed under a reliable system with adequate controls.
- Data were subjected to audit testing in the current or prior year.
- Expectations were developed using data from a variety of sources.

N88
Answer 5 (10 points)

a. The means or techniques of gathering audit evidence, in addition to the example, are as follows:

Technique	*Description*
Inquiry	An auditor questions client personnel about events and conditions, such as obsolete inventory.
Confirmation	An auditor obtains acknowledgments in writing from third parties of transactions or balances, such as inventory in public warehouses or on consignment.
Calculation or Recomputation	An auditor recomputes certain amounts, such as the multiplication of quantity times price to determine inventory amounts.
Analysis	An auditor combines amounts in meaningful ways to allow the application of audit judgment, such as the determination of whether a proper inventory cutoff was performed.
Inspection	An auditor examines documents relating to transactions and balances, such as shipping and receiving records to establish ownership of inventory.
Comparison	An auditor relates two or more amounts, such as inventory cost in perpetual inventory records to costs as shown on vendor invoices as part of the evaluation of whether inventory is priced at the lower of cost or market.

b. Substantive auditing procedures that would satisfy the five general assertions regarding a client's inventory balance include the following:

(one different procedure required for each assertion)

Assertion	*Substantive Auditing Procedure*
1. Existence or Occurrence	• Observe physical inventory counts. • Obtain confirmation of inventories at locations outside the entity. • Test inventory transactions between a preliminary physical inventory date and the balance sheet date. • Review perpetual inventory records, production records, and purchasing records for indications of current activity. • Compare inventories with a current sales catalog and subsequent sales and delivery reports. • Use the work of specialists to corroborate the nature of specialized products.
2. Completeness	• Observe physical inventory counts. • Analytically review the relationship of inventory balances to recent purchasing, production, and sales activities. • Test shipping and receiving cutoff procedures. • Obtain confirmation of inventories at locations outside the entity. • Trace test counts recorded during the physical inventory observation to the inventory listing. • Account for all inventory tags and count sheets used in recording the physical inventory counts. • Test the clerical accuracy of inventory listings. • Reconcile physical counts to perpetual records and general ledger balances and investigate significant fluctuations.
3. Rights and Obligations	• Observe physical inventory counts. • Obtain confirmation of inventories at locations outside the entity. • Examine paid vendors' invoices, consignment agreements, and contracts. • Test shipping and receiving cutoff procedures.
4. Valuation or Allocation	• Examine paid vendors' invoices. • Review direct labor rates. • Test the computation of standard overhead rates. • Examine analyses of purchasing and manufacturing standard cost variances. • Examine an analysis of inventory turnover. • Review industry experience and trends. • Analytically review the relationship of inventory balances to anticipated sales volume. • Tour the plant. • Inquire of production and sales personnel concerning possible excess or obsolete inventory items. • Obtain current market value quotations. • Review current production costs. • Examine sales after year-end and open purchase order commitments.
5. Presentation and Disclosure	• Review drafts of the financial statements. • Compare the disclosures made in the financial statements to the requirements of generally accepted accounting principles. • Obtain confirmation of inventories pledged under loan agreements.

B. Specific Audit Objectives and Procedures

N91
Answer 4

b. Larkin should consider applying the following additional substantive auditing procedures in auditing Vernon's investments:

- Inspect securities on hand in the presence of the custodian.
- Examine supporting evidence (broker's advices, etc.) for transactions between the balance sheet date and the inspection date.
- Obtain confirmation from the issuers or trustees for investments in nonpublic entities.
- Examine contractual terms of debt securities and preferred stock.
- Determine that sales and purchases were properly approved by the Board of Directors or its designee.
- Examine broker's advices in support of transactions or confirm transactions with broker.
- Determine that gains and losses on dispositions have been properly computed.
- Trace payments for purchases to canceled checks, and proceeds from sales to entries in the cash receipts journal.
- Determine that the amortization of premium and discount on bonds has been properly computed.
- Determine that market value for both current and long-term portfolios has been properly computed by tracing quoted market prices to competent published or other sources.
- Compute the unrealized gains and losses on both current and long-term portfolios for marketable equity securities.
- Determine that the unrealized gains and losses on the current portfolio have been properly classified in the income statement, and the unrealized gains and losses on the noncurrent portfolio have been properly classified in the equity section of the balance sheet.
- Ascertain whether any investments are pledged as collateral or encumbered by liens, and, if so, are properly disclosed.

M91
Answer 3 (10 points)

a. Taylor should consider performing the following procedures in the audit of Palmer's goodwill:

- Trace the totals in the account analysis for each significant acquisition to the general ledger;
- Trace the opening balance to the audit working papers for the preceding year;
- Examine supporting documents for evidence of continued ownership of the acquisitions that resulted in excess of costs over fair value of net assets;
- Review the reasonableness and consistency of application of the method of amortization used;
- Determine that the amortization period is reasonable;
- Recompute amortization;
- Determine that the carrying amount does not exceed amounts properly allocable to future periods;
- Assess whether there has been a permanent impairment of value;
- Trace amounts amortized during the period to the related general ledger expense accounts;
- Examine evidence supporting additions and reductions during the year (e.g., contingency payments properly capitalizable, reductions due to recovery of preacquisition taxes, etc.);
- Ascertain whether goodwill and amortization are properly described and classified in the financial statements and disclosed in the notes to the financial statements.

b. The two significant assertions that Taylor would be most concerned with relative to Palmer's goodwill are valuation or allocation, and presentation and disclosure. Taylor would be most concerned with the risk of the loss of recoverablity of the goodwill's market value due to not meeting profit expectations, and the risk of inadequate disclosure or presentation in the financial statements.

N90
Answer 4 (10 points)

The substantive audit procedures Kane should apply to Star's trade accounts payable balances include the following:

- Foot the schedule of the trade accounts payable.
- Agree the total of the schedule to the general ledger trial balance.
- Compare a sample of individual account balances from the schedule with the accounts payable subsidiary ledger.
- Compare a sample of individual account balances from the accounts payable subsidiary ledger with the schedule.
- Investigate and discuss with management any old or disputed payables.

- Investigate debit balances and, if significant, consider requesting positive confirmations and propose reclassification of the amounts.
- Review the minutes of board of directors' meetings and any written agreements and inquire of key employees as to whether any assets are pledged to collateralize payables.
- Performing cut-off tests.
- Performing analytical procedures.

Confirm or verify recorded accounts payable balances by:

- Reviewing the voucher register or subsidiary accounts payable ledger and consider confirming payables of a sample of vendors.
- Requesting a sample of vendors to provide statements of account balances as of the date selected.
- Investigating and reconciling differences discovered during the confirmation procedures.
- Testing a sample of unconfirmed balances by examining the related vouchers, invoices, purchase orders, and receiving reports.

Perform a search for unrecorded liabilities by:

- Examining files of receiving reports unmatched with vendors' invoices, searching for items received before the balance sheet date but not yet billed or on the schedule.
- Inspecting files of unprocessed invoices, purchase orders, and vendors' statements.
- Reviewing support for the cash disbursements journal, the voucher register, or canceled checks for disbursements after the balance sheet date to identify transactions that should have been recorded at the balance sheet date, but were not.
- Inquiring of key employees about additional sources of unprocessed invoices or other trade payables.

N89
Answer 2 (10 points)

Bell should consider performing the following procedures in the audit of Kent's payroll transactions:

Select a sample of payments to employees from the payroll register and compare each selected transaction to the related documents and records examining

- Evidence in support of authorization of rate of pay.
- Evidence in support of time on which compensation was based, such as approved time cards or attendance records.
- Evidence in support of proper authorization of payroll withholdings.
- Evidence in support of payment, such as canceled payroll checks.
- Evidence in support of account distribution.
- The clerical accuracy of the transaction.
- The entry to the employee's records used to summarize employee compensation for payroll reporting purposes.

Obtain the payroll register for a selected period and

- Test the arithmetical accuracy of the payroll register.
- Determine whether payroll was approved in accordance with management's prescribed procedures.
- Trace totals per the register to postings in the general ledger.

Observe the distribution of payroll checks.
Review the accounting for unclaimed wages.
Observe a sample of employees in the performance of their duties.
Perform analytical procedures.

M89
Answer 4 (10 points)

Edwards should consider applying the following additional substantive audit procedures:

- Test the accuracy of the aged accounts receivable schedule.
- Send second requests for all unanswered positive confirmation requests.
- Perform alternative auditing procedures for unanswered second confirmation requests.
- Reconcile and investigate exceptions reported on the confirmations.
- Project the results of the sample confirmation procedures to the population and evaluate the confirmation results.
- Determine whether any accounts receivable are owed by employees or related parties.
- Test the cut-off of sales, cash receipts, and sales returns and allowances.
- Evaluate the reasonableness of the allowance for doubtful accounts.
- Perform analytical procedures for accounts receivable (e.g., accounts receivable to credit sales, allowance for doubtful accounts to accounts receivable, sales to returns and allowances, doubtful accounts expense to net credit sales).
- Identify differences, if any, between the book and tax basis for the allowance for doubtful accounts and related expense.
- Review activity after the balance sheet date for unusual transactions.
- Determine that the presentation and disclosure of accounts receivable is in conformity with generally accepted accounting principles consistently applied.

M88
Answer 3 (10 points)

The substantive audit procedures that Young should apply when testing for loss contingencies relating to litigation, claims, and assessments include the following:

- Read minutes of meetings of stockholders, directors, and committees.
- Read contracts, loan agreements, leases, and other documents.
- Read correspondence with taxing and other governmental agencies.
- Read correspondence with insurance and bonding companies.
- Read confirmation replies for information concerning guarantees.
- Discuss with management the entity's policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management or inside general counsel a description and evaluation of litigation, claims, and assessments.
- Obtain written assurance from management that the financial statements include all accruals and disclosures required by Statement on Financial Accounting Standards No. 5.
- Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence from lawyers.
- Obtain an analysis of professional fee expenses and review supporting invoices for indications of contingencies.
- Request the client's management to prepare for transmittal a letter of inquiry to those lawyers consulted by the client concerning litigation, claims, and assessments.
- Compare the lawyer's response to the items in the letter of inquiry to the description and evaluation of litigation, claims, and assessments obtained from management.
- Determine that the financial statements include proper accruals and disclosures of the contingencies.

C. Other Specific Audit Topics

M92
Answer 4 (10 points)

The substantive auditing procedures Brown may consider performing include the following:

Using the perpetual inventory file,

- Recalculate the beginning and ending balances (prices × quantities), foot, and print out a report to be used to reconcile the totals with the general ledger (or agree beginning balance with the prior year's working papers).

- Calculate the quantity balances as of the physical inventory date for comparison to the physical inventory file. (Alternatively, update the physical inventory file for purchases and sales from January 6 to January 31, 1992, for comparison to the perpetual inventory at Janaury 31, 1992.)

- Select and print out a sample of items received and shipped for the periods a) before and after January 5 and 31, 1992, for cut-off testing, b) between January 5 and January 31, 1992, for vouching or analytical procedures, and c) prior to January 5, 1992, for tests of details or analytical procedures.

- Compare quantities sold during the year to quantities on hand at year end. Print out a report of items for which turnover is less than expected. (Alternatively, calculate the number of days' sales in inventory for selected items.)

- Select items noted as possibly unsalable or obsolete during the physical inventory observation and print out information about purchases and sales for further consideration.

- Recalculate the prices used to value the year-end FIFO inventory by matching prices and quantities to the most recent purchases.

- Select a sample of items for comparison to current sales prices.

- Identify and print out unusual transactions. (These are transactions other than purchases or sales for the year, or physical inventory adjustments as of January 5, 1992.)

- Recalculate the ending inventory (or selected items) by taking the beginning balances plus purchases, less sales (quantities and/or amounts), and print out the differences.

- Recalculate the cost of sales for selected items sold during the year.

Using the physical inventory and test count files,

- Account for all inventory tag numbers used and print out a report of missing or duplicate numbers for follow-up.

- Search for tag numbers noted during the physical inventory observation as being voided or not used.

- Compare the physical inventory file to the file of test counts and print out a report of differences for auditor follow-up.

- Combine the quantities for each item appearing on more than one inventory tag number for comparison to the perpetual file.

- Compare the quantities on the file to the calculated quantity balances on the perpetual inventory file as of January 5, 1992. (Alternatively, compare the physical inventory file updated to year end to the perpetual inventory file.)

- Calculate the quantities and dollar amounts of the book-to-physical adjustments for each item and the total adjustment. Print out a report to reconcile the total adjustment to the adjustment recorded in the general ledger before year end.

- Using the calculated book-to-physical adjustments for each item, compare the quantities and dollar amounts of each adjustment to the perpetual inventory file as of January 5, 1992, and print out a report of differences for follow-up.

M90
Answer 4 (10 points)

a. The first type of subsequent events includes those events that provide additional evidence concerning conditions that existed at the balance sheet date and affect the estimates inherent in the process of preparing financial statements. This type of subsequent events requires that the financial statements be adjusted for any changes in estimates resulting from the use of such additional evidence.

The second type of subsequent events consists of those events that provide evidence concerning conditions that did not exist at the balance sheet date but arose subsequent to that date. These events should not result in adjustment to the financial statements but may be such that disclosure is required to keep the financial statements from being misleading.

b. The auditing procedures Green should consider performing to gather evidence concerning subsequent events include the following:

- Compare the latest available interim statements with the financial statements being audited.
- Ascertain whether the interim statements were prepared on the same basis as the audited financial statements.
- Inquire whether any contingent liabilities or commitments existed at the balance sheet date or the date of inquiry.
- Inquire whether there was any significant change in the capital stock, long-term debt, or working capital to the date of inquiry.
- Inquire about the current status of items in the audited financial statements that were accounted for on the basis of tentative, preliminary, or inconclusive data.
- Inquire about any unusual adjustments made since the balance sheet date.
- Read or inquire about the minutes of meetings of stockholders or the board of directors.
- Inquire of the client's legal counsel concerning litigation, claims, and assessments.
- Obtain a management representation letter, dated as of the date of Green's report, as to whether any subsequent events would require adjustment or disclosure.
- Make such additional inquiries or perform such additional procedures Green considers necessary and appropriate.

N88
Answer 2 (10 points)

The audit procedures Temple should apply to identify Ford's related party relationships and transactions include the following:

- Evaluate the company's procedures for identifying and properly reporting related party relationships and transactions.
- Request from management the names of all related parties and inquire whether there were any transactions with these parties during the period.
- Review tax returns and filings with other regulatory agencies for the names of related parties.
- Determine the names of all pension plans and other trusts and the names of their officers and trustees.
- Review stock certificate book to identify the stockholders.
- Review material investment transactions to determine whether the investments created related party relationships.
- Review the minutes of board of directors' meetings.
- Review conflict-of-interest statements obtained by the company from its management.
- Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders.
- Consider whether transactions are occurring, but are not being given proper accounting recognition, e.g., personal use of company vehicles, interest-free loans, etc.
- Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
- Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.
- Review invoices from law firms that have performed services for the company for indications of the existence of related party relationships or transactions.
- Review confirmations of loans receivable and payable for indications of guarantees, and determine their nature and the relationships, if any, of the guarantors to the reporting entity.

IV. Reporting

A. Reporting Standards and Types of Reports

N91
Answer 2 (10 points)

1. Statement 1 is appropriate.

2. Statement 2 is appropriate.

3. Statement 3 is not appropriate because the auditors are required to plan and perform the audit to provide reasonable assurance of detecting instances of noncompliance having a direct and material effect on the financial statements, not all instances of noncompliance.

4. Statement 4 is appropriate.

5. Statement 5 is not appropriate because rendering an opinion is a higher level of reporting than the positive and negative assurance required by *Government Auditing Standards.*

6. Statement 6 is appropriate.

7. Statement 7 is not appropriate because negative assurance applies to items **not** tested.

8. Statement 8 is not appropriate because *Government Auditing Standards* require that, unless restricted by law or regulation, copies of the reports should be made available for public inspection.

M91
Answer 2 (10 points)

The auditors' report contains the following deficiencies:

1. "Independent" is omitted from the title of the auditors' report.

<u>**Introductory paragraph**</u>

2. Management's responsibility for the financial statements is omitted.

3. The auditors' responsibility to express an opinion on the financial statements is omitted.

<u>**Scope paragraph**</u>

4. "Generally accepted auditing standards" should be referred to, not standards established by the AICPA.

5. Reference to assessing "significant estimates made by management" is omitted.

6. The concluding statement that the auditors "believe that our audits provide a reasonable basis for our opinion" is omitted.

<u>**Explanatory paragraph**</u>

7. Reference to the income tax basis of accounting as "a comprehensive basis of accounting other than generally accepted accounting principles" is omitted.

8. The statement that the financial statements are "not designed for those who do not have access to the Partnership tax returns" is inappropriate.

<u>**Opinion paragraph**</u>

9. The income tax basis of accounting "described in Note A" should be referred to, not "generally accepted accounting principles."

10. There should be no reference to consistency unless the accounting principles have not been applied consistently.

N90
Answer 5 (10 points)

Deficiencies in the report on the compiled financial statements are as follows:

Within the first paragraph

- The financial statements are not properly identified.
- Standards established by the AICPA should be referred to.
- The expression "to obtain limited assurance" should not be used.

Within the second paragraph

- The information is not stated to be the representation of management.
- The phrase "less in scope than an audit" is inappropriate.
- Reference to the financial statements not being reviewed is omitted.
- Reference to "any other form of assurance" is omitted.

Within the third paragraph

- Reference to the omission of the statement of cash flows is omitted.
- There should be a statement that the financial statements are not designed for those uninformed about the omitted disclosures.
- It is inappropriate to refer to changes in financial position.

Within the fourth paragraph

- The reason for the accountant's lack of independence should not be described.

Inclusion of the fifth paragraph is inappropriate.

The accountant's compilation report is not dated October 25, 1990.

M90
Answer 2 (10 points)

Independent Auditor's Report

To the Board of Directors of Johnson Company:

We have audited the accompanying balance sheets of Johnson Company as of December 31, 1989 and 1988, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

We did not observe the taking of the physical inventory as of December 31, 1987, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 1987, enter into the determination of net income and cash flows for the year ended December 31, 1988.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 1988.

In our opinion, the balance sheets of Johnson Company as of December 31, 1989 and 1988, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 1989 present fairly, in all material respects, the financial position of Johnson Company as of December 31, 1989 and 1988, and the results of its operations and its cash flows for the year ended December 31, 1989, in conformity with generally accepted accounting principles.

Friday & Co., CPAs
March 11, 1990

M89
Answer 2 (10 points)

The auditor's report contains the following deficiencies:

Opening (introductory) paragraph

1. All the financial statements audited are not identified.

2. Management's responsibility for the financial statements is omitted.

Scope paragraph

3. Reference to "generally accepted auditing standards" is omitted.

4. An auditor obtains reasonable assurance about whether the financial statements are "free of material misstatement," not "in conformity with generally accepted accounting principles."

5. The statement that an audit includes "evaluating the overall financial statement presentation" is omitted.

6. The statement that the auditors "believe that our audit provides a reasonable basis for our opinion" is omitted.

Explanatory paragraph

7. The explanatory paragraph should follow the opinion paragraph.

8. The auditors should not give an opinion concerning the entity's survival "beyond a reasonable period of time."

Opinion paragraph

9. A qualified ("subject to") opinion is inappropriate.

10. The date of the financial statements audited is omitted.

11. There should be no reference to consistency unless the accounting principles have not been applied consistently.

N88
Answer 4 (10 points)

Deficiencies in the staff assistant's draft are as follows:

Within the first paragraph

- The statement of cash flow is not identified.
- Standards established by the AICPA, not generally accepted auditing standards, should be referred to.
- The financial statements are not stated to be the representations of management.
- The phrase "our review included such tests of the accounting records as we considered necessary in the circumstances" is inappropriate.

Within the second paragraph

- The phrase "analytical procedures applied to financial data" is omitted.
- The phrase "more in scope than a compilation" is inappropriate.
- An opinion should be disclaimed.
- "Limited assurance" should not be expressed.

Within the third paragraph

- Reference to the "exception" in the third paragraph when it has been restated is inappropriate.
- Reference to consistency is inappropriate.

Within the fourth paragraph

- There should be reference to the prior year's review report.
- There should be reference to generally accepted accounting principles.

M88
Answer 2

b. The accountant's standard report on a compilation of a financial projection should include

- An identification of the projection presented by the responsible party.
- A statement that the accountant has compiled the projection in accordance with standards established by the AICPA.
- A separate paragraph that describes the limitations on the use of the presentation.
- A statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the projection or the assumptions.
- A caveat that the prospective results may not be achieved.
- A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

Uniform CPA Examination/May 1988 – May 1992

Business Law

Selected Questions And Unofficial Answers Indexed To Content Specification Outline

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* No other objective answer formats or essays were indexed for this area or group.
† Questions in this area are not classified according to group.
‡ No essays were indexed for this group.

MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. The CPA and the Law

A. Common Law Liability to Clients and Third Persons

N91#1. Cable Corp. orally engaged Drake & Co., CPAs, to audit its financial statements. Cable's management informed Drake that it suspected the accounts receivable were materially overstated. Though the financial statements Drake audited included a materially overstated accounts receivable balance, Drake issued an unqualified opinion. Cable used the financial statements to obtain a loan to expand its operations. Cable defaulted on the loan and incurred a substantial loss.

If Cable sues Drake for negligence in failing to discover the overstatement, Drake's best defense would be that Drake did **not**

a. Have privity of contract with Cable.
b. Sign an engagement letter.
c. Perform the audit recklessly or with an intent to deceive.
d. Violate generally accepted auditing standards in performing the audit.

N91#2. When performing an audit, a CPA

a. Must exercise the level of care, skill, and judgment expected of a reasonably prudent CPA under the circumstances.
b. Must strictly adhere to generally accepted accounting principles.
c. Is strictly liable for failing to discover client fraud.
d. Is **not** liable unless the CPA commits gross negligence or intentionally disregards generally accepted auditing standards.

N91#3. Ford & Co., CPAs, issued an unqualified opinion on Owens Corp.'s financial statements. Relying on these financial statements, Century Bank lent Owens \$750,000. Ford was unaware that Century would receive a copy of the financial statements or that Owens would use them to obtain a loan. Owens defaulted on the loan.

To succeed in a common law fraud action against Ford, Century must prove, in addition to other elements, that Century was

a. Free from contributory negligence.
b. In privity of contract with Ford.
c. Justified in relying on the financial statements.
d. In privity of contract with Owens.

N91#4. Hark, CPA, failed to follow generally accepted auditing standards in auditing Long Corp.'s financial statements. Long's management had told Hark that the audited statements would be submitted to several banks to obtain financing. Relying on the statements, Third Bank gave Long a loan. Long defaulted on the loan. In a jurisdiction applying the *Ultramares* decision, if Third sues Hark, Hark will

a. Win because there was **no** privity of contract between Hark and Third.
b. Lose because Hark knew that banks would be relying on the financial statements.
c. Win because Third was contributorily negligent in granting the loan.
d. Lose because Hark was negligent in performing the audit.

N91#5. A CPA who fraudulently performs an audit of a corporation's financial statements will

a. Probably be liable to any person who suffered a loss as a result of the fraud.
b. Be liable only to the corporation and to third parties who are members of a class of intended users of the financial statements.
c. Probably be liable to the corporation even though its management was aware of the fraud and did **not** rely on the financial statements.
d. Be liable only to third parties in privity of contract with the CPA.

N90#1. A CPA firm issues an unqualified opinion on financial statements not prepared in accordance with GAAP. The CPA firm will have acted with scienter in all the following circumstances **except** where the firm

a. Intentionally disregards the truth.
b. Has actual knowledge of fraud.
c. Negligently performs auditing procedures.
d. Intends to gain monetarily by concealing fraud.

N90#2. A CPA owes a duty to

a. Provide for a successor CPA in the event death or disability prevents completion of an audit.
b. Advise a client of errors contained in a previously filed tax return.
c. Disclose client fraud to third parties.
d. Perform an audit according to GAAP so that fraud will be uncovered.

N90#3. Mell Corp. engaged Davis & Co., CPAs, to audit Mell's financial statements. Mell's management informed Davis it suspected that the accounts receivable were materially overstated. Although the financial statements did include a materially overstated accounts receivable balance, Davis issued an unqualified opinion. Mell relied on the financial statements in deciding to obtain a loan from County Bank to expand its operations. County relied on the financial statements in making the loan to Mell. As a result of the overstated accounts receivable balance, Mell has defaulted on the loan and has incurred a substantial loss.

If County sues Davis for fraud, must Davis furnish County with the audit working papers?

a. Yes, if the working papers are lawfully subpoenaed into court.
b. Yes, provided that Mell does **not** object.
c. No, because of the privileged communication rule, which is recognized in a majority of jurisdictions.
d. No, because County was **not** in privity of contract with Davis.

N90#4. In a common law action against an accountant, lack of privity is a viable defense if the plaintiff

a. Can prove the presence of gross negligence which amounts to a reckless disregard for the truth.
b. Bases the action upon fraud.
c. Is the client's creditor who sues the accountant for negligence.
d. Is the accountant's client.

N90#5. Mix and Associates, CPAs, issued an unqualified opinion on the financial statements of Glass Corp. for the year ended December 31, 1989. It was determined later that Glass' treasurer had embezzled $300,000 from Glass during 1989. Glass sued Mix because of Mix's failure to discover the embezzlement. Mix was unaware of the embezzlement. Which of the following is Mix's best defense?

a. The audit was performed in accordance with GAAS.
b. The treasurer was Glass' agent and, therefore, Glass was responsible for preventing the embezzlement.
c. The financial statements were presented in conformity with GAAP.
d. Mix had **no** actual knowledge of the embezzlement.

M89#1. Krim, President and CEO of United Co., engaged Smith, CPA, to audit United's financial statements so that United could secure a loan from First Bank. Smith issued an unqualified opinion on May 20, 1988, but the loan was delayed. On August 5, 1988, on inquiry to Smith by First Bank, Smith, relying on Krim's representation, made assurances that there was no material change in United's financial status. Krim's representation was untrue because of a material change which took place after May 20, 1988. First relied on Smith's assurances of no change. Shortly thereafter, United became insolvent. If First sues Smith for negligent misrepresentation, Smith will be found

a. Not liable, because Krim misled Smith, and a CPA is **not** responsible for a client's untrue representations.
b. Liable, because Smith should have undertaken sufficient auditing procedures to verify the status of United.
c. Not liable, because Smith's opinion only covers the period up to May 20.
d. Liable, because Smith should have contacted the chief financial officer rather than the chief executive officer.

M89#2. If a stockholder sues a CPA for common law fraud based on false statements contained in the financial statements audited by the CPA, which of the following, if present, would be the CPA's best defense?

a. The stockholder lacks privity to sue.
b. The false statements were immaterial.
c. The CPA did **not** financially benefit from the alleged fraud.
d. The contributory negligence of the client.

M89#6. When CPAs fail in their duty to carry out their contracts for services, liability to clients may be based on

	Breach of contract	*Strict liability*
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M89#7. Which one of the following, if present, would support a finding of constructive fraud on the part of a CPA?

a. Privity of contract.
b. Intent to deceive.
c. Reckless disregard.
d. Ordinary negligence.

M88#2. Mead Corp. orally engaged Dex & Co., CPAs, to audit its financial statements. The management of Mead informed Dex that it suspected that the accounts receivable were materially overstated. Although the financial statements audited by Dex did, in fact, include a materially overstated accounts receivable balance, Dex issued an unqualified opinion. Mead relied on the financial statements in deciding to obtain a loan from City Bank to expand its operations. City relied on the financial statements in making the loan to Mead. As a result of the overstated accounts receivable balance, Mead has defaulted on the loan and has incurred a substantial loss.

If City sues Dex for fraud, Dex would most likely avoid liability if it could prove that

a. Dex was **not** in privity of contract with City.
b. Dex did **not** perform the audit recklessly or with an intent to deceive.
c. Mead should have provided more specific information concerning its suspicions.
d. Mead was contributorily negligent.

B. Federal Statutory Liability

M92

Items 2 through 5 are based on the following:

Dart Corp. engaged Jay Associates, CPAs, to assist in a public stock offering. Jay audited Dart's financial statements and gave an unqualified opinion, despite knowing that the financial statements contained misstatements. Jay's opinion was included in Dart's registration statement. Larson purchased shares in the offering and suffered a loss when the stock declined in value after the misstatements became known.

2. In a suit against Jay and Dart under the Section 11 liability provisions of the Securities Act of 1933, Larson must prove that
   a. Jay knew of the misstatements.
   b. Jay was negligent.
   c. The misstatements contained in Dart's financial statements were material.
   d. The unqualified opinion contained in the registration statement was relied on by Larson.

3. If Larson succeeds in the Section 11 suit against Dart, Larson would be entitled to
   a. Damages of three times the original public offering price.
   b. Rescind the transaction.
   c. Monetary damages only.
   d. Damages, but only if the shares were resold before the suit was started.

4. In a suit against Jay under the anti-fraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, Larson must prove all of the following **except**
   a. Larson was an intended user of the false registration statement.
   b. Larson relied on the false registration statement.
   c. The transaction involved some form of interstate commerce.
   d. Jay acted with intentional disregard of the truth.

5. If Larson succeeds in the Section 10(b) and Rule 10b-5 suit, Larson would be entitled to
   a. Only recover the original public offering price.
   b. Only rescind the transaction.
   c. The amount of any loss caused by the fraud.
   d. Punitive damages.

N91#6. Quincy bought Teal Corp. common stock in an offering registered under the Securities Act of 1933. Worth & Co., CPAs, gave an unqualified opinion on Teal's financial statements that were included in the registration statement filed with the SEC. Quincy sued Worth under the provisions of the 1933 Act that deal with omission of facts required to be in the registration statement. Quincy must prove that
   a. There was fraudulent activity by Worth.
   b. There was a material misstatement in the financial statements.
   c. Quincy relied on Worth's opinion.
   d. Quincy was in privity with Worth.

N91#7. For a CPA to be liable for damages under the antifraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934, a plaintiff must prove all of the following **except** that
   a. The plaintiff relied on the financial statements audited by the CPA.
   b. The CPA violated generally accepted auditing standards.
   c. There was a material misrepresentation of fact in the financial statements audited by the CPA.
   d. The CPA acted with scienter.

N91#8. Jay, CPA, gave an unqualified opinion on Nast Power Co.'s financial statements. Larkin bought Nast bonds in a public offering subject to the Securities Act of 1933. The registration statement filed with the SEC included Nast's financial statements. Larkin sued Jay for misstatements contained in the financial statements under the provisions of Section 11 of the Securities Act of 1933. To prevail, Larkin must prove

	Scienter	*Reliance*
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

N91#9. A CPA who prepares clients' federal income tax returns for a fee must
   a. File certain required notices and powers of attorney with the IRS before preparing any returns.
   b. Keep a completed copy of each return for a specified period of time.
   c. Receive client documentation supporting all travel and entertainment expenses deducted on the return.
   d. Indicate the CPA's federal identification number on a tax return only if the return reflects tax due from the taxpayer.

N90#6. Holly Corp. engaged Yost & Co., CPAs, to audit the financial statements to be included in a registration statement Holly was required to file under the provisions of the Securities Act of 1933. Yost failed to exercise due diligence and did not discover the omission of a fact material to the statements. A purchaser of Holly's securities may recover from Yost under Section 11 of the Securities Act of 1933 only if the purchaser

a. Brings a civil action within one year of the discovery of the omission and within three years of the offering date.
b. Proves that the registration statement was relied on to make the purchase.
c. Proves that Yost was negligent.
d. Establishes privity of contract with Yost.

N90
Items 7 and 8 are based on the following:

Petty Corp. made a public offering subject to the Securities Act of 1933. In connection with the offering, Ward & Co., CPAs, rendered an unqualified opinion on Petty's financial statements included in the SEC registration statement. Huff purchased 500 of the offered shares. Huff has brought an action against Ward under Section 11 of the Securities Act of 1933 for losses resulting from misstatements of facts in the financial statements included in the registration statement.

7. To succeed, Huff must prove that
   a. Ward performed the audit negligently.
   b. The misstatements were material.
   c. Ward rendered its opinion with knowledge of material misstatements.
   d. Huff relied on the financial statements included in the registration statement.

8. Ward's weakest defense would be that
   a. Huff knew of the misstatements when Huff purchased the stock.
   b. Huff's losses were **not** caused by the misstatements.
   c. Ward was **not** in privity of contract with Huff.
   d. Ward conducted the audit in accordance with GAAS.

M89#3. Tax preparers who aid and abet federal tax evasion are subject to

	Injunction to be prohibited from acting as tax preparers	*General federal criminal prosecution*
a.	No	No
b.	Yes	No
c.	No	Yes
d.	Yes	Yes

M89#4. Brown, CPA, helped Cook organize a partnership that was actually an abusive tax shelter. Brown induced clients to participate by making false statements concerning the allowability of deductions and tax credits. As a result of these activities, Cook derived \$100,000 gross income and Brown derived \$50,000 gross income. What is Brown's federal statutory liability under the provision of the Internal Revenue Code specifically relating to promoting abusive tax shelters?

a. \$ 10,000
b. \$ 30,000
c. \$ 50,000
d. \$150,000

M89#8. Burt, CPA, issued an unqualified opinion on the financial statements of Midwest Corp. These financial statements were included in Midwest's annual report and Form 10-K filed with the SEC. As a result of Burt's reckless disregard for GAAS, material misstatements in the financial statements were not detected. Subsequently, Davis purchased stock in Midwest in the secondary market without ever seeing Midwest's annual report or Form 10-K. Shortly thereafter, Midwest became insolvent and the price of the stock declined drastically. Davis sued Burt for damages based on Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Burt's best defense is that

a. There has been **no** subsequent sale for which a loss can be computed.
b. Davis did **not** purchase the stock as part of an initial offering.
c. Davis did **not** rely on the financial statements or Form 10-K.
d. Davis was **not** in privity with Burt.

M88#8. West & Co., CPAs, was engaged by Sand Corp. to audit its financial statements. West issued an unqualified opinion on Sand's financial statements. Sand has been accused of making negligent misrepresentations in the financial statements, which Reed relied upon when purchasing Sand stock. West was not aware of the misrepresentations nor was it negligent in performing the audit. If Reed sues West for damages based upon Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934, West will

a. Lose, because Reed relied upon the financial statements.
b. Lose, because the statements contained negligent misrepresentations.
c. Prevail, because some element of scienter must be proved.
d. Prevail, because Reed was **not** in privity of contract with West.

M88#9. In general, if the IRS issues a 30-day letter to an individual taxpayer who wishes to dispute the assessment, the taxpayer

a. May, without paying any tax, immediately file a petition that would properly commence an action in Tax Court.
b. May ignore the 30-day letter and wait to receive a 90-day letter.
c. Must file a written protest within 10 days of receiving the letter.
d. Must pay the taxes and then commence an action in federal district court.

C. Workpapers, Privileged Communication, and Confidentiality

M92#1. In a jurisdiction having an accountant-client privilege statute, to whom may a CPA turn over workpapers without a client's permission?

a. Purchaser of the CPA's practice.
b. State tax authorities.
c. State court.
d. State CPA society quality control panel.

N91#10. Which of the following statements is correct with respect to ownership, possession, or access to a CPA firm's audit workpapers?

a. Workpapers are subject to the privileged communication rule which, in most jurisdictions, prevents any third-party access to the workpapers.
b. Workpapers may **never** be obtained by third parties unless the client consents.
c. Workpapers are the client's exclusive property.
d. Workpapers are **not** transferable to a purchaser of a CPA practice unless the client consents.

N90#9. Locke, CPA, was engaged to perform an audit for Vorst Co. During the audit, Locke discovered that Vorst's inventory contained stolen goods. Vorst was indicted and Locke was validly subpoenaed to testify at the criminal trial. Vorst has claimed accountant-client privilege to prevent Locke from testifying. Locke may be compelled to testify

a. Only with Vorst's consent.
b. In any federal court located in the 50 states.
c. In any state court.
d. Only about the nature of the work performed in the audit.

N90#10. A CPA partnership may, without being lawfully subpoenaed or without the client's consent, make client workpapers available to

a. An individual purchasing the entire partnership.
b. The IRS.
c. The SEC.
d. Any surviving partner(s) on the death of a partner.

M89#5. A CPA is permitted to disclose confidential client information without the consent of the client to

I. Another CPA who has purchased the CPA's tax practice.
II. A successor CPA firm if the information concerns suspected tax return irregularities.
III. A voluntary quality control review board.

a. I and III only.
b. II and III only.
c. II only.
d. III only.

II. Business Organizations

A. Agency

M92#6. A principal and agent relationship requires a

a. Written agreement.
b. Power of attorney.
c. Meeting of the minds and consent to act.
d. Specified consideration.

M92#7. Young was a purchasing agent for Wilson, a sole proprietor. Young had the express authority to place purchase orders with Wilson's suppliers. Young conducted business through the mail and had little contact with Wilson. Young placed an order with Vanguard, Inc. on Wilson's behalf after Wilson was declared incompetent in a judicial proceeding. Young was aware of Wilson's incapacity. With regard to the contract with Vanguard, Wilson (or Wilson's legal representative) will

a. Not be liable because Vanguard dealt only with Young.
b. Not be liable because Young did **not** have authority to enter into the contract.
c. Be liable because Vanguard was unaware of Wilson's incapacity.
d. Be liable because Young acted with express authority.

M92#8. Long Corp. is a real estate developer and regularly engages real estate brokers to act on its behalf in acquiring parcels of land. The brokers are authorized to enter into such contracts, but are instructed to do so in their own names without disclosing Long's identity or Long's relationship to the transaction. If a broker enters into a contract with a seller on Long's behalf,

a. Long will **not** be liable for any negligent acts committed by the broker while acting on Long's behalf.
b. The broker will have the same actual authority as if Long's identity had been disclosed.
c. The broker will **not** be personally bound by the contract because the broker has express authority to act.
d. Long will be bound by the contract because of the broker's apparent authority.

M92#9. Ogden Corp. hired Thorp as a sales representative for nine months at a salary of $3,000 per month plus 4% of sales. Which of the following statements is correct?

a. Thorp is obligated to act solely in Ogden's interest in matters concerning Ogden's business.
b. The agreement between Ogden and Thorp formed an agency coupled with an interest.
c. Ogden does **not** have the power to dismiss Thorp during the nine-month period without cause.
d. The agreement between Ogden and Thorp is **not** enforceable unless it is in writing and signed by Thorp.

N91#11. Forming an agency relationship requires that

a. The agreement between the principal and agent be supported by consideration.
b. The principal and agent **not** be minors.
c. Both the principal and agent consent to the agency.
d. The agent's authority be limited to the express grant of authority in the agency agreement.

N91#12. When an agent acts for an undisclosed principal, the principal will **not** be liable to third parties if the

a. Principal ratifies a contract entered into by the agent.
b. Agent acts within an implied grant of authority.
c. Agent acts outside the grant of actual authority.
d. Principal seeks to conceal the agency relationship.

N91#13. Orr gives North power of attorney. In general, the power of attorney

a. Will be valid only if North is a licensed attorney at law.
b. May continue in existence after Orr's death.
c. May limit North's authority to specific transactions.
d. Must be signed by both Orr and North.

M91#1. Simpson, Ogden Corp.'s agent, needs a written agency agreement to

a. Enter into a series of sales contracts on Ogden's behalf.
b. Hire an attorney to collect a business debt owed Ogden.
c. Purchase an interest in undeveloped land for Ogden.
d. Retain an independent general contractor to renovate Ogden's office building.

M91#2. Kent, without authority, contracted to buy computer equipment from Fox Corp. for Ace Corp. Kent told Fox that Kent was acting on Ace's behalf. For Ace to ratify the contract with Fox,

a. Kent must be a general agent of Ace.
b. Ace must know all material facts relating to the contract at the time it is ratified.
c. Ace must notify Fox that Ace intends to ratify the contract.
d. Kent must have acted reasonably and in Ace's best interest.

M91#3. Frost's accountant and business manager has the authority to

a. Mortgage Frost's business property.
b. Obtain bank loans for Frost.
c. Insure Frost's property against fire loss.
d. Sell Frost's business.

M90#1. Generally, an agency relationship is terminated by operation of law in all of the following situations **except** the

a. Principal's death.
b. Principal's incapacity.
c. Agent's renunciation of the agency.
d. Agent's failure to acquire a necessary business license.

M90#2. Pine, an employee of Global Messenger Co., was hired to deliver highly secret corporate documents for Global's clients throughout the world. Unknown to Global, Pine carried a concealed pistol. While Pine was making a delivery, he suspected an attempt was being made to steal the package, drew his gun and shot Kent, an innocent passerby. Kent will **not** recover damages from Global if

a. Global discovered that Pine carried a weapon and did nothing about it.
b. Global instructed its messengers **not** to carry weapons.
c. Pine was correct and an attempt was being made to steal the package.
d. Pine's weapon was unlicensed and illegal.

M90#4. Able, as agent for Baker, an undisclosed principal, contracted with Safe to purchase an antique car. In payment, Able issued his personal check to Safe. Able could not cover the check but expected Baker to give him cash to deposit before the check was presented for payment. Baker did not do so and the check was dishonored. Baker's identity became known to Safe. Safe may **not** recover from

a. Baker individually on the contract.
b. Able individually on the contract.
c. Baker individually on the check.
d. Able individually on the check.

M90#5. Ace engages Butler to manage Ace's retail business. Butler has the implied authority to do all of the following, **except**

a. Purchase inventory for Ace's business.
b. Sell Ace's business fixtures.
c. Pay Ace's business debts.
d. Hire or discharge Ace's business employees.

N89#2. A principal will **not** be liable to a third party for a tort committed by an agent

a. Unless the principal instructed the agent to commit the tort.
b. Unless the tort was committed within the scope of the agency relationship.
c. If the agency agreement limits the principal's liability for the agent's tort.
d. If the tort is also regarded as a criminal act.

N89#3. Parc contracted with Furn Brothers Corp. to buy hotel furniture and fixtures on behalf of Global Motor House, a motel chain. Global instructed Parc to use Parc's own name and not to disclose to Furn that Parc was acting on Global's behalf. Who is liable to Furn on this contract?

	Parc	*Global*
a.	Yes	No
b.	No	Yes
c.	Yes	Yes
d.	No	No

M89#11. Pell is the principal and Astor is the agent in an agency coupled with an interest. In the absence of a contractual provision relating to the duration of the agency, who has the right to terminate the agency before the interest has expired?

	Pell	*Astor*
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

M89#12. Neal, an employee of Jordan, was delivering merchandise to a customer. On the way, Neal's negligence caused a traffic accident that resulted in damages to a third party's automobile. Who is liable to the third party?

	Neal	*Jordan*
a.	No	No
b.	Yes	Yes
c.	Yes	No
d.	No	Yes

M89#13. Simmons, an agent for Jensen, has the express authority to sell Jensen's goods. Simmons also has the express authority to grant discounts of up to 5% of list price. Simmons sold Hemple goods with a list price of $1,000 and granted Hemple a 10% discount. Hemple had not previously dealt with either Simmons or Jensen. Which of the following courses of action may Jensen properly take?

a. Seek to void the sale to Hemple.
b. Seek recovery of $50 from Hemple only.
c. Seek recovery of $50 from Simmons only.
d. Seek recovery of $50 from either Hemple or Simmons.

N88#2. Harris is a purchasing agent for Elkin, a sole proprietor. Harris has the express authority to place purchase orders with Elkin's suppliers. Harris typically conducts business through the mail and has very little contact with Elkin. Elkin was incapacitated by a stroke and was declared incompetent in a judicial proceeding. Subsequently, Harris placed an order with Ajax, Inc. on behalf of Elkin. Neither Ajax nor Harris were aware of Elkin's incapacity. With regard to the contract with Ajax, Elkin (or Elkin's legal representative) will

a. Not be liable because Harris was without authority to enter into the contract.
b. Not be liable provided that Harris had placed orders with Ajax in the past.
c. Be liable because Harris was acting within the scope of Harris' authority.
d. Be liable because Ajax was unaware of Elkin's incapacity.

M88

Items 4 and 5 are based on the following information:

Able, on behalf of Pix Corp., entered into a contract with Sky Corp., by which Sky agreed to sell computer equipment to Pix. Able disclosed to Sky that she was acting on behalf of Pix. However, Able had exceeded her actual authority by entering into the contract with Sky.

4. If Pix does **not** want to honor the contract, it will nonetheless be held liable if Sky can prove that

a. Able had apparent authority to bind Pix.
b. Able believed she was acting within the scope of her authority.
c. Able was an employee of Pix and **not** an independent contractor.
d. The agency relationship between Pix and Able was formalized in a signed writing.

5. If Pix wishes to ratify the contract with Sky, which of the following statements is correct?

a. Pix must notify Sky that Pix intends to ratify the contract.
b. Able must have acted reasonably and in Pix's best interest.
c. Able must be a general agent of Pix.
d. Pix must have knowledge of all material facts relating to the contract at the time it is ratified.

M88#6. The apparent authority of a general agent for a disclosed principal will terminate without notice to third parties when the

a. Principal dismisses the agent.
b. Principal or agent dies.
c. Purpose of the agency relationship has been fulfilled.
d. Time period set forth in the agency agreement has expired.

B. Partnerships and Joint Ventures

M92#10. A partnership agreement must be in writing if
- a. Any partner contributes more than $500 in capital.
- b. The partners reside in different states.
- c. The partnership intends to own real estate.
- d. The partnership's purpose **cannot** be completed within one year of formation.

M92#11. Which of the following statements is correct with respect to a limited partnership?
- a. A limited partner may **not** be an unsecured creditor of the limited partnership.
- b. A general partner may **not** also be a limited partner at the same time.
- c. A general partner may be a secured creditor of the limited partnership.
- d. A limited partnership can be formed with limited liability for all partners.

M92
Items 12 and 13 are based on the following:

Dowd, Elgar, Frost, and Grant formed a general partnership. Their written partnership agreement provided that the profits would be divided so that Dowd would receive 40%; Elgar, 30%; Frost, 20%; and Grant, 10%. There was no provision for allocating losses. At the end of its first year, the partnership had losses of $200,000. Before allocating losses, the partners' capital account balances were: Dowd, $120,000; Elgar, $100,000; Frost, $75,000; and Grant, $11,000. Grant refuses to make any further contributions to the partnership. Ignore the effects of federal partnership tax law.

12. What would be Grant's share of the partnership losses?
- a. $ 9,000
- b. $20,000
- c. $39,000
- d. $50,000

13. After losses were allocated to the partners' capital accounts and all liabilities were paid, the partnership's sole asset was $106,000 in cash. How much would Elgar receive on dissolution of the partnership?
- a. $37,000
- b. $40,000
- c. $47,500
- d. $50,000

M92#14. Blake, a partner in QVM, a general partnership, wishes to withdraw from the partnership and sell her interest to Nolan. All of the other partners in QVM have agreed to admit Nolan as a partner and to hold Blake harmless for the past, present, and future liabilities of QVM. As a result of Blake's withdrawal and Nolan's admission to the partnership, Nolan
- a. Must contribute cash or property to QVM to be admitted with the same rights as the other partners.
- b. Is personally liable for partnership liabilities arising before and after being admitted as a partner.
- c. Has the right to participate in QVM's management.
- d. Acquired only the right to receive Nolan's share of QVM's profits.

N91#14. A general partnership must
- a. Pay federal income tax.
- b. Have two or more partners.
- c. Have written articles of partnership.
- d. Provide for apportionment of liability for partnership debts.

N91#15. In a general partnership, the authorization of all partners is required for an individual partner to bind the partnership in a business transaction to
- a. Purchase inventory.
- b. Hire employees.
- c. Sell goodwill.
- d. Sign advertising contracts.

N91#16. In a general partnership, a partner's interest in specific partnership property is
- a. Transferable to a partner's individual creditors.
- b. Subject to a partner's liability for alimony.
- c. Transferable to a partner's estate upon death.
- d. Subject to a surviving partner's right of survivorship.

N91#17. On dissolution of a general partnership, distributions will be made on account of:

- I. Partners' capital accounts
- II. Amounts owed partners with respect to profits
- III. Amounts owed partners for loans to the partnership

in the following order
- a. III, I, II.
- b. I, II, III.
- c. II, III, I.
- d. III, II, I.

N90#11. Which of the following is **not** necessary to create an express partnership?
- a. Execution of a written partnership agreement.
- b. Agreement to share ownership of the partnership.
- c. Intention to conduct a business for profit.
- d. Intention to create a relationship recognized as a partnership.

N90#12. Eller, Fort, and Owens do business as Venture Associates, a general partnership. Trent Corp. brought a breach of contract suit against Venture and Eller individually. Trent won the suit and filed a judgment against both Venture and Eller. Trent will generally be able to collect the judgment from

a. Partnership assets only.
b. The personal assets of Eller, Fort, and Owens only.
c. Eller's personal assets only after partnership assets are exhausted.
d. Eller's personal assets only.

N90#13. Acorn and Bean were general partners in a farm machinery business. Acorn contracted, on behalf of the partnership, to purchase 10 tractors from Cobb Corp. Unknown to Cobb, Acorn was not authorized by the partnership agreement to make such contracts. Bean refused to allow the partnership to accept delivery of the tractors and Cobb sought to enforce the contract. Cobb will

a. Lose because Acorn's action was beyond the scope of Acorn's implied authority.
b. Prevail because Acorn had implied authority to bind the partnership.
c. Prevail because Acorn had apparent authority to bind the partnership.
d. Lose because Acorn's express authority was restricted, in writing, by the partnership agreement.

N90#14. Lewis, Clark, and Beal entered into a written agreement to form a partnership. The agreement required that the partners make the following capital contributions: Lewis, $40,000; Clark, $30,000; and Beal, $10,000. It was also agreed that in the event the partnership experienced losses in excess of available capital, Beal would contribute additional capital to the extent of the losses. The partnership agreement was otherwise silent about division of profits and losses. Which of the following statements is correct?

a. Profits are to be divided among the partners in proportion to their relative capital contributions.
b. Profits are to be divided equally among the partners.
c. Losses will be allocated in a manner different from the allocation of profits because the partners contributed different amounts of capital.
d. Beal's obligation to contribute additional capital would have an effect on the allocation of profit or loss to Beal.

N89#4. A joint venture is a(an)

a. Association limited to no more than two persons in business for profit.
b. Enterprise of numerous co-owners in a nonprofit undertaking.
c. Corporate enterprise for a single undertaking of limited duration.
d. Association of persons engaged as co-owners in a single undertaking for profit.

N89#5. Which of the following statements regarding a limited partner is(are) generally correct?

	The limited partner is subject to personal liability for partnership debts	*The limited partner has the right to take part in the control of the partnership*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N89#6. Gillie, Taft, and Dall are partners in an architectural firm. The partnership agreement is silent about the payment of salaries and the division of profits and losses. Gillie works full-time in the firm, and Taft and Dall each work half-time. Taft invested $120,000 in the firm, and Gillie and Dall invested $60,000 each. Dall is responsible for bringing in 50% of the business, and Gillie and Taft 25% each. How should profits of $120,000 for the year be divided?

a. Gillie $60,000, Taft $30,000, Dall $30,000.
b. Gillie $40,000, Taft $40,000, Dall $40,000.
c. Gillie $30,000, Taft $60,000, Dall $30,000.
d. Gillie $30,000, Taft $30,000, Dall $60,000.

N89#7. A partner's interest in specific partnership property is

	Assignable to the partner's individual creditors	*Subject to attachment by the partner's individual creditors*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M89#14. Rivers and Lee want to form a partnership. For the partnership agreement to be enforceable, it must be in writing if

a. Rivers and Lee reside in different states.
b. The agreement cannot be completed within one year from the date on which it will be entered into.
c. Either Rivers or Lee is to contribute more than $500 in capital.
d. The partnership intends to buy and sell real estate.

M89#15. Cass is a general partner in Omega Company general partnership. Which of the following unauthorized acts by Cass will bind Omega?

a. Submitting a claim against Omega to arbitration.
b. Confessing a judgment against Omega.
c. Selling Omega's goodwill.
d. Leasing office space for Omega.

M89#16. Kroll, Inc., a partner in JKL Partnership, assigns its interest in the partnership to Trell, who is not made a partner. After the assignment, Trell asserts the rights to

I. Receive Kroll's share of JKL's profits and
II. Inspect JKL's books and records.

Trell is correct as to which of the rights?

a. I only.
b. II only.
c. I and II.
d. Neither I nor II.

N88#4. In general, which of the following statements is correct with respect to a limited partnership?

a. A limited partner has the right to obtain from the general partner(s) financial information and tax returns of the limited partnership.
b. A limited partnership can be formed with limited liability for all partners.
c. A limited partner may **not** also be a general partner at the same time.
d. A limited partner may hire employees on behalf of the partnership.

M88#7. Dill was properly admitted as a partner in the ABC Partnership after purchasing Ard's partnership interest. Ard immediately withdrew from the partnership. The partnership agreement states that the partnership will continue on the withdrawal or admission of a partner. Unless the partners otherwise agree,

a. Dill's personal liability for partnership debts incurred before Dill was admitted will be limited to Dill's interest in partnership property.
b. Ard will automatically be released from personal liability for partnership debts incurred before Dill's admission.
c. Ard will be permitted to recover from the other partners the full amount that Ard has paid on account of partnership debts incurred before Dill's admission.
d. Dill will be subjected to unlimited personal liability for partnership debts incurred before being admitted.

M88#13. X, Y, and Z have capital balances of $30,000, $15,000, and $5,000, respectively, in the XYZ Partnership. The general partnership agreement is silent as to the manner in which partnership losses are to be allocated but does provide that partnership profits are to be allocated as follows: 40% to X, 25% to Y, and 35% to Z. The partners have decided to dissolve and liquidate the partnership. After paying all creditors, the amount available for distribution will be $20,000. X, Y, and Z are individually solvent. Under the circumstances, Z will

a. Receive $7,000.
b. Receive $12,000.
c. Personally have to contribute an additional $5,500.
d. Personally have to contribute an additional $5,000.

M88#14. Grey and Carr entered into a written partnership agreement to operate a hardware store. Their agreement was silent as to the duration of the partnership. Grey wishes to dissolve the partnership. Which of the following statements is correct?

a. Unless Carr consents to a dissolution, Grey must apply to a court and obtain a decree ordering the dissolution.
b. Grey may not dissolve the partnership unless Carr consents.
c. Grey may dissolve the partnership only after notice of the proposed dissolution is given to all partnership creditors.
d. Grey may dissolve the partnership at any time.

C. Corporations

M92#15. Assuming all other requirements are met, a corporation may elect to be treated as an S corporation under the Internal Revenue Code if it has

a. Both common and preferred stockholders.
b. A partnership as a stockholder.
c. Thirty-five or fewer stockholders.
d. The consent of a majority of the stockholders.

M92#16. Generally, a corporation's articles of incorporation must include all of the following **except** the

a. Name of the corporation's registered agent.
b. Name of each incorporator.
c. Number of authorized shares.
d. Quorum requirements.

M92#17. Unless prohibited by the organization documents, a stockholder in a publicly held corporation and the owner of a limited partnership interest both have the right to

a. Ownership of the business' assets.
b. Control management of the business.
c. Assign their interest in the business.
d. An investment that has perpetual life.

M92#18. A corporate stockholder is entitled to which of the following rights?

a. Elect officers.
b. Receive annual dividends.
c. Approve dissolution.
d. Prevent corporate borrowing.

M92#19. Price owns 2,000 shares of Universal Corp.'s $10 cumulative preferred stock. During its first year of operations, cash dividends of $5 per share were declared on the preferred stock but were never paid. In the second year, dividends on the preferred stock were neither declared nor paid. If Universal is dissolved, which of the following statements is correct?

a. Universal will be liable to Price as an unsecured creditor for $10,000.
b. Universal will be liable to Price as a secured creditor for $20,000.

c. Price will have priority over the claims of Universal's bond owners.
d. Price will have priority over the claims of Universal's unsecured judgment creditors.

M92#20. Which of the following actions may a corporation take without its stockholders' consent?
a. Consolidate with one or more corporations.
b. Merge with one or more corporations.
c. Dissolve voluntarily.
d. Purchase 55% of another corporation's stock.

M91#4. Which of the following statements is correct with respect to the differences and similarities between a corporation and a limited partnership?
a. Stockholders may be entitled to vote on corporate matters but limited partners are prohibited from voting on any partnership matters.
b. Stock of a corporation may be subject to the registration requirements of the federal securities laws but limited partnership interests are automatically exempt from those requirements.
c. Directors owe fiduciary duties to the corporation and limited partners owe such duties to the partnership.
d. A corporation and a limited partnership may be created only under a state statute and each must file a copy of its organizational document with the proper governmental body.

M91#5. Davis, a director of Active Corp., is entitled to
a. Serve on the board of a competing business.
b. Take sole advantage of a business opportunity that would benefit Active.
c. Rely on information provided by a corporate officer.
d. Unilaterally grant a corporate loan to one of Active's shareholders.

M91#6. The limited liability of a stockholder in a closely held corporation may be challenged successfully if the stockholder
a. Undercapitalized the corporation when it was formed.
b. Formed the corporation solely to have limited personal liability.
c. Sold property to the corporation.
d. Was a corporate officer, director, or employee.

M91#7. A consolidation of two corporations usually requires all of the following **except**
a. Approval by the board of directors of each corporation.
b. Receipt of voting stock by all stockholders of the original corporations.
c. Provision for an appraisal buyout of dissenting stockholders.
d. An affirmative vote by the holders of a majority of each corporation's voting shares.

N90#15. Knox, president of Quick Corp., contracted with Tine Office Supplies, Inc. to supply Quick's stationery on customary terms and at a cost less than that charged by any other supplier. Knox later informed Quick's board of directors that Knox was a majority stockholder in Tine. Quick's contract with Tine is
a. Void because of Knox's self-dealing.
b. Void because the disclosure was made after execution of the contract.
c. Valid because of Knox's full disclosure.
d. Valid because the contract is fair to Quick.

N90#16. A stockholder's right to inspect books and records of a corporation will be properly denied if the purpose of the inspection is to
a. Commence a stockholder's derivative suit.
b. Obtain stockholder names for a retail mailing list.
c. Solicit stockholders to vote for a change in the board of directors.
d. Investigate possible management misconduct.

N90#17. All of the following distributions to stockholders are considered asset or capital distributions, **except**
a. Liquidating dividends.
b. Stock splits.
c. Property distributions.
d. Cash dividends.

N90#18. Opal Corp. declared a 9% stock dividend on its common stock. The dividend
a. Requires a vote of Opal's stockholders.
b. Has **no** effect on Opal's earnings and profits for federal income tax purposes.
c. Is includable in the gross income of the recipient taxpayers in the year of receipt.
d. Must be registered with the SEC pursuant to the Securities Act of 1933.

M90#6. In general, which of the following must be contained in articles of incorporation?
a. Names of the initial officers and their terms of office.
b. Classes of stock authorized for issuance.
c. Names of states in which the corporation will be doing business.
d. Name of the state in which the corporation will maintain its principal place of business.

M90#7. Absent a specific provision in its articles of incorporation, a corporation's board of directors has the power to do all of the following, **except**
a. Repeal the bylaws.
b. Declare dividends.
c. Fix compensation of directors.
d. Amend the articles of incorporation.

M90#8. An owner of common stock will **not** have any liability beyond actual investment if the owner
a. Paid less than par value for stock purchased in connection with an original issue of shares.
b. Agreed to perform future services for the corporation in exchange for original issue par value shares.
c. Purchased treasury shares for less than par value.
d. Failed to pay the full amount owed on a subscription contract for no-par shares.

M90#9. Johns owns 400 shares of Abco Corp. cumulative preferred stock. In the absence of any specific contrary provisions in Abco's articles of incorporation, which of the following statements is correct?
a. Johns is entitled to convert the 400 shares of preferred stock to a like number of shares of common stock.
b. If Abco declares a cash dividend on its preferred stock, Johns becomes an unsecured creditor of Abco.
c. If Abco declares a dividend on its common stock, Johns will be entitled to participate with the common stock shareholders in any dividend distribution made after preferred dividends are paid.
d. Johns will be entitled to vote if dividend payments are in arrears.

N88#5. Which of the following statements is correct with respect to the differences and similarities between a corporation and a limited partnership?
a. Directors owe fiduciary duties to the corporation and limited partners owe such duties to the partnership.
b. A corporation and a limited partnership may be created only pursuant to a state statute and a copy of its organizational document must be filed with the proper state agency.
c. Shareholders may be entitled to vote on corporate matters whereas limited partners are prohibited from voting on any partnership matters.
d. Stock of a corporation may be subject to the federal securities laws registration requirements whereas limited partnership interests are automatically exempt from such requirements.

N88#7. The limited liability of the shareholders of a closely-held corporation will most likely be disregarded if the shareholders
a. Lend money to the corporation.
b. Are also corporate officers, directors, or employees.
c. Undercapitalized the corporation when it was formed.
d. Formed the corporation solely to limit their personal liability.

M88#15. In general, which of the following statements concerning treasury stock is correct?
a. A corporation may **not** reacquire its own stock unless specifically authorized by its articles of incorporation.
b. On issuance of new stock, a corporation has preemptive rights with regard to its treasury stock.
c. Treasury stock may be distributed as a stock dividend.
d. A corporation is entitled to receive cash dividends on its treasury stock.

D. Estates and Trusts

N91#18. Which of the following is **not** necessary to create an express trust?
a. A trust corpus.
b. A successor trustee.
c. A valid trust purpose.
d. A beneficiary.

N91#19. A trustee's fiduciary duty will probably be violated if the trustee
a. Invests trust property in government bonds.
b. Performs accounting services for the trust.
c. Sells unproductive trust property.
d. Borrows money from the trust.

N91#20. An irrevocable spendthrift trust established for a period of ten years will be terminated if the
a. Income beneficiaries die.
b. Trustee resigns.
c. Income beneficiaries agree to the trust's termination.
d. Grantor decides to terminate the trust.

M91#8. To properly create an inter vivos trust funded with cash, the grantor must
a. Execute a written trust instrument.
b. Transfer the cash to the trustee.
c. Provide for payment of fees to the trustee.
d. Designate an alternate trust beneficiary.

M91#9. Farrel's will created a testamentary trust naming Gordon as life income beneficiary, with the principal going to Hall on Gordon's death. The trust's sole asset was a commercial office building valued at $200,000. The trustee sold the building for $250,000. To what amount of the sale price is Gordon entitled?
a. $0
b. $ 50,000
c. $200,000
d. $250,000

M91#10. Mason's will created a testamentary trust for the benefit of Mason's spouse. Mason's sister and Mason's spouse were named as co-trustees of the trust. The trust provided for discretionary principal distributions to Mason's spouse. It also provided that, on the death of Mason's spouse, any remaining trust property was to be distributed to Mason's children. Part of the trust property consisted of a very valuable coin collection. After Mason's death, which of the following statements would be correct?

a. Mason's spouse may **not** be a co-trustee because the spouse is also a beneficiary of the trust.
b. Mason's sister may delegate her duties as co-trustee to the spouse and thereby **not** be liable for the administration of the trust.
c. Under **no** circumstances could the spouse purchase the coin collection from the trust without breaching fiduciary duties owed to the trust and Mason's children.
d. The co-trustees must use the same degree of skill, judgment, and care in managing the trust assets as reasonably prudent persons would exercise in managing their own affairs.

N90#19. Which of the following expenditures resulting from a trust's ownership of commercial real estate would be allocated to the trust's principal?

a. Sidewalk assessments.
b. Building management fees.
c. Real estate taxes.
d. Electrical repairs.

N90#20. A trust will be terminated if

a. A beneficiary becomes incompetent.
b. The trustee dies.
c. The grantor dies.
d. The trust term expires.

M90#10. Jay properly created an inter vivos trust naming Kroll as trustee. The trust's sole asset is a fully rented office building. Rental receipts exceed expenditures. The trust instrument is silent about the allocation of items between principal and income. Among the items to be allocated by Kroll during the year are insurance proceeds received as a result of fire damage to the building and the mortgage interest payments made during the year. Which of the following items is(are) properly allocable to principal?

	Insurance proceeds on building	*Current mortgage interest payments*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

N89#8. Harper transferred assets into a trust under which Drake is entitled to receive the income for life. Upon Drake's death, the remaining assets are to be paid to Neal. In 1988, the trust received rent of $1,000, royalties of $3,000, cash dividends of $5,000, and proceeds of $7,000 from the sale of stock previously received by the trust as a stock dividend. Both Drake and Neal are still alive. How much of the receipts should be distributed to Drake?

a. $ 4,000.
b. $ 8,000.
c. $ 9,000.
d. $16,000.

M89#17. Generally, an estate is liable for which debts owed by the decedent at the time of death?

a. All of the decedent's debts.
b. Only debts secured by the decedent's property.
c. Only debts covered by the statute of frauds.
d. None of the decedent's debts.

M89#18. A trust agreement is silent on the allocation of the following trust receipts between principal and income:

• Cash dividends on investments in common stock	$1,000
• Royalties from property subject to depletion	$2,000

What is the total amount of the trust receipts that should be allocated to trust income?

a. $0
b. $1,000
c. $2,000
d. $3,000

M89#19. A personal representative of an estate would breach fiduciary duties if the personal representative

a. Combined personal funds with funds of the estate so that both could purchase treasury bills.
b. Represented the estate in a lawsuit brought against it by a disgruntled relative of the decedent.
c. Distributed property in satisfaction of the decedent's debts.
d. Engaged a non-CPA to prepare the records for the estate's final accounting.

M89#20. A trust was created in 1980 to provide funds for sending the settlor's child through medical school. The trust agreement specified that the trust was to terminate in 1987. The child entered medical school in 1983, took a leave of absence in 1984, and died in 1986. This trust terminated in

a. 1983
b. 1984
c. 1986
d. 1987

N88#6. Krieg's will created a trust to take effect upon Krieg's death. The will named Krieg's spouse as both the trustee and personal representative (executor) of the estate. The will provided that all of Krieg's securities were to be transferred to the trust and named Krieg's child as the beneficiary of the trust. Under the circumstances,

a. Krieg has created a testamentary trust.
b. Krieg's spouse may **not** serve as both the trustee and personal representative because of the inherent conflict of interest.
c. Krieg has created an inter vivos trust.
d. The trust is invalid because it will **not** become effective until Krieg's death.

N88

Items 8 and 9 are based on the following:

On January 1, 1988, Dix transferred certain assets into a trust. The assets consisted of Lux Corp. bonds with a face amount of $500,000 and an interest rate of 12%. The trust instrument named Dix as trustee, Dix's child as life beneficiary, and Dix's grandchild as remainderman. Interest on the bonds is payable semi-annually on May 1 and November 1. Dix had purchased the bonds at their face amount. As of January 1, 1988, the bonds had a fair market value of $600,000. The accounting period selected for the trust is a calendar year. The trust instrument is silent as to whether Dix may revoke the trust.

8. Which of the following statements is correct?
   a. Dix is **not** a fiduciary because Dix is also the creator (settlor).
   b. The trust is invalid under the merger doctrine because Dix is both the creator and the trustee.
   c. A duty is owed by Dix to administer the trust property for the sole benefit of the beneficiaries.
   d. Dix has the implied right to revoke the trust without the court's permission.

9. Assuming the trust is valid, how should the amount of interest received in 1988 be allocated between principal and income if the trust instrument is otherwise silent?

	Principal	*Income*
a.	$0	$60,000
b.	$0	$72,000
c.	$10,000	$50,000
d.	$12,000	$60,000

M88#10. To create a valid inter vivos trust to hold personal property, the trust must be

a. In writing and signed by the settlor (creator).
b. Specific concerning the property to be held in trust.
c. Irrevocable.
d. In writing and signed by the trustee.

M88#12. Rusk properly created an inter vivos trust naming Gold as the trustee. The sole asset of the trust is an office building that is fully rented. Rental receipts exceed expenditures. The trust instrument is silent as to the allocation of items between principal and income. Which of the following statements is correct concerning Gold's responsibility as trustee?

a. Gold's duty of loyalty will be breached by Gold's purchasing assets from the trust despite a provision in the trust agreement permitting such a purchase.
b. Gold owes a duty of loyalty to the trust but **not** to the beneficiaries.
c. Gold must exercise reasonable care and skill while performing the duties of a trustee.
d. Gold will be free from personal liability with regard to all contracts entered into by Gold on behalf of the trust absent fraud by Gold.

III. Contracts

A. Offer and Acceptance

M92#21. On September 10, Harris, Inc., a new car dealer, placed a newspaper advertisement stating that Harris would sell 10 cars at its showroom for a special discount only on September 12, 13, and 14. On September 12, King called Harris and expressed an interest in buying one of the advertised cars. King was told that five of the cars had been sold and to come to the showroom as soon as possible. On September 13, Harris made a televised announcement that the sale would end at 10:00 PM that night. King went to Harris' showroom on September 14 and demanded the right to buy a car at the special discount. Harris had sold the 10 cars and refused King's demand. King sued Harris for breach of contract. Harris' best defense to King's suit would be that Harris'

a. Offer was unenforceable.
b. Advertisement was **not** an offer.
c. Television announcement revoked the offer.
d. Offer had **not** been accepted.

M92#22. On April 1, Fine Corp. faxed Moss an offer to purchase Moss' warehouse for $500,000. The offer stated that it would remain open only until April 4 and that acceptance must be received to be effective. Moss sent an acceptance on April 4 by overnight mail and Fine received it on April 5. Which of the following statements is correct?

a. No contract was formed because Moss sent the acceptance by an unauthorized method.
b. No contract was formed because Fine received Moss' acceptance after April 4.
c. A contract was formed when Moss sent the acceptance.
d. A contract was formed when Fine received Moss' acceptance.

M91#11. Nix sent Castor a letter offering to employ Castor as controller of Nix's automobile dealership. Castor received the letter on February 19. The letter provided that Castor would have until February 23 to consider the offer and, in the meantime, Nix would not withdraw it. On February 20, Nix, after reconsidering the offer to Castor, decided to offer the job to Vick, who accepted immediately. That same day, Nix called Castor and revoked the offer. Castor told Nix that an acceptance of Nix's offer was mailed on February 19. Under the circumstances,

a. Nix's offer was irrevocable until February 23.
b. No contract was formed between Nix and Castor because Nix revoked the offer before Nix received Castor's acceptance.
c. Castor's acceptance was effective when mailed.
d. Any revocation of the offer would have to be in writing because Nix's offer was in writing.

M91#12. Carson Corp., a retail chain, asked Alto Construction to fix a broken window at one of Carson's stores. Alto offered to make the repairs within three days at a price to be agreed on after the work was completed. A contract based on Alto's offer would fail because of indefiniteness as to the

a. Price involved.
b. Nature of the subject matter.
c. Parties to the contract.
d. Time for performance.

M90#12. On September 27, Summers sent Fox a letter offering to sell Fox a vacation home for $150,000. On October 2, Fox replied by mail agreeing to buy the home for $145,000. Summers did not reply to Fox. Do Fox and Summers have a binding contract?

a. No, because Fox failed to sign and return Summers' letter.
b. No, because Fox's letter was a counteroffer.
c. Yes, because Summers' offer was validly accepted.
d. Yes, because Summers' silence is an implied acceptance of Fox's letter.

M90#13. On November 1, Yost sent a telegram to Zen offering to sell a rare vase. The offer required that Zen's acceptance telegram be sent on or before 5:00 P.M. on November 2. On November 2, at 3:00 P.M., Zen sent an acceptance by overnight mail. It did not reach Yost until November 5. Yost refused to complete the sale to Zen. Is there an enforceable contract?

a. Yes, because the acceptance was made within the time specified.
b. Yes, because the acceptance was effective when sent.
c. No, because Zen did **not** accept by telegram.
d. No, because the offer required receipt of the acceptance within the time specified.

M90#14. Opal offered, in writing, to sell Larkin a parcel of land for $300,000. If Opal dies, the offer will

a. Terminate prior to Larkin's acceptance only if Larkin received notice of Opal's death.
b. Remain open for a reasonable period of time after Opal's death.
c. Automatically terminate despite Larkin's prior acceptance.
d. Automatically terminate prior to Larkin's acceptance.

N89#9. The mailbox rule generally makes acceptance of an offer effective at the time the acceptance is dispatched. The mailbox rule does **not** apply if

a. Both the offeror and offeree are merchants.
b. The offer proposes a sale of real estate.
c. The offer provides that an acceptance shall **not** be effective until actually received.
d. The duration of the offer is **not** in excess of three months.

M89#21. Martin wrote Dall and offered to sell Dall a building for $200,000. The offer stated it would expire 30 days from April 1. Martin changed his mind and does not wish to be bound by his offer. If a legal dispute arises between the parties regarding whether there has been a valid acceptance of the offer, which one of the following is correct?

a. The offer cannot be legally withdrawn for the stated period of time.
b. The offer will **not** expire before the 30 days even if Martin sells the property to a third person and notifies Dall.
c. If Dall categorically rejects the offer on April 10, Dall cannot validly accept within the remaining stated period of time.
d. If Dall phoned Martin on May 3, and unequivocally accepted the offer, a contract would be created, provided that Dall had **no** notice of withdrawal of the offer.

M89#22. Which of the following statements concerning the effectiveness of an offeree's rejection and an offeror's revocation of an offer is generally correct?

	An offeree's rejection is effective when	*An offeror's revocation is effective when*
a.	Received by offeror	Sent by offeror
b.	Sent by offeree	Received by offeree
c.	Sent by offeree	Sent by offeror
d.	Received by offeror	Received by offeree

M89#23. An offer is **not** terminated by operation of law solely because the

a. Offeror dies.
b. Offeree is adjudicated insane.
c. Subject matter is destroyed.
d. Subject matter is sold to a third party.

M89#25. To announce the grand opening of a new retail business, Hudson placed an advertisement in a local newspaper quoting sales prices on certain items in stock. The grand opening was so successful that Hudson was unable to totally satisfy customer demands. Which of the following statements is correct?

a. Hudson made an invitation seeking offers.
b. Hudson made an offer to the people who read the advertisement.
c. Anyone who tendered money for the items advertised was entitled to buy them.
d. The offer by Hudson was partially revocable as to an item once it was sold out.

N88#10. The president of Deal Corp. wrote to Boyd, offering to sell the Deal factory for $300,000. The offer was sent by Deal on June 5 and was received by Boyd on June 9. The offer stated that it would remain open until December 20. The offer

a. Constitutes an enforceable option.
b. May be revoked by Deal any time prior to Boyd's acceptance.
c. Is a firm offer under the UCC but will be irrevocable for only three months.
d. Is a firm offer under the UCC because it is in writing.

N88
Items 11 and 12 are based on the following:

On April 2, Jet Co. wrote to Ard, offering to buy Ard's building for $350,000. The offer contained all of the essential terms to form a binding contract and was duly signed by Jet's president. It further provided that the offer would remain open until May 30 and an acceptance would not be effective until received by Jet. On April 10, Ard accepted Jet's offer by mail. The acceptance was received by Jet on April 14.

11. *For this item only,* assume that on April 11 Jet sent a telegram to Ard revoking its offer and that Ard received the telegram on April 12. Under the circumstances,

a. A contract was formed on April 10.
b. A contract was formed on April 14.
c. Jet's revocation effectively terminated its offer on April 12.
d. Jet's revocation effectively terminated its offer on April 11.

12. *For this item only,* assume that on April 13 Ard sent a telegram to Jet withdrawing the acceptance and rejecting Jet's offer and that Jet received the telegram on April 15. Under the circumstances,

a. A contract was formed on April 14.
b. A contract was formed on April 10.
c. Ard's rejection effectively terminated Jet's offer on April 13.
d. Ard's rejection effectively terminated Jet's offer on April 15.

M88#16. In order for an offer to confer the power to form a contract by acceptance, it must have all of the following elements **except**

a. Be communicated to the offeree and the communication must be made or authorized by the offeror.
b. Be sufficiently definite and certain.
c. Be communicated by words to the offeree by the offeror.
d. Manifest an intent to enter into a contract.

M88#17. On July 1, Silk, Inc., sent Blue a telegram offering to sell Blue a building for $80,000. In the telegram, Silk stated that it would give Blue 30 days to accept the offer. On July 15, Blue sent Silk a telegram that included the following statement: "The price for your building seems too high. Would you consider taking $75,000?" This telegram was received by Silk on July 16. On July 19, Tint made an offer to Silk to purchase the building for $82,000. Upon learning of Tint's offer, Blue, on July 27, sent Silk a signed letter agreeing to purchase the building for $80,000. This letter was received by Silk on July 29. However, Silk now refuses to sell Blue the building. If Blue commences an action against Silk for breach of contract, Blue will

a. Win, because Blue effectively accepted Silk's offer of July 1.
b. Win, because Silk was obligated to keep the offer open for the 30-day period.
c. Lose, because Blue sent the July 15 telegram.
d. Lose, because Blue used an unauthorized means of communication.

B. Consideration

M92#23. Which of the following will be legally binding despite lack of consideration?

a. An employer's promise to make a cash payment to a deceased employee's family in recognition of the employee's many years of service.
b. A promise to donate money to a charity on which the charity relied in incurring large expenditures.
c. A modification of a signed contract to purchase a parcel of land.
d. A merchant's oral promise to keep an offer open for 60 days.

M92#24. In which of the following situations does the first promise serve as valid consideration for the second promise?

a. A police officer's promise to catch a thief for a victim's promise to pay a reward.
b. A builder's promise to complete a contract for a purchaser's promise to extend the time for completion.
c. A debtor's promise to pay $500 for a creditor's promise to forgive the balance of a $600 liquidated debt.
d. A debtor's promise to pay $500 for a creditor's promise to forgive the balance of a $600 disputed debt.

M91#16. Kay, an art collector, promised Hammer, an art student, that if Hammer could obtain certain rare artifacts within two weeks, Kay would pay for Hammer's postgraduate education. At considerable effort and expense, Hammer obtained the specified artifacts within the two-week period. When Hammer requested payment, Kay refused. Kay claimed that there was no consideration for the promise. Hammer would prevail against Kay based on

a. Unilateral contract.
b. Unjust enrichment.
c. Public policy.
d. Quasi contract.

N90#21. Which of the following requires consideration to be binding on the parties?

a. Material modification of a contract involving the sale of real estate.
b. Ratification of a contract by a person after reaching the age of majority.
c. A written promise signed by a merchant to keep an offer to sell goods open for 10 days.
d. Material modification of a sale of goods contract under the UCC.

M90#11. To satisfy the consideration requirement for a valid contract, the consideration exchanged by the parties must be

a. Legally sufficient.
b. Payable in legal tender.
c. Simultaneously paid and received.
d. Of the same economic value.

M90#16. Which of the following will be legally binding on all parties despite lack of consideration?

a. An irrevocable oral promise by a merchant to keep an offer open for 60 days.
b. A promise to donate money to a charity which the charity relied upon in incurring large expenditures.
c. A promise to pay for the college education of the child of a person who saved the promisor's life.
d. A signed modification to a contract to purchase a parcel of land.

N89#10. For there to be consideration for a contract, there must be

a. A bargained-for detriment to the promisor(ee) or a benefit to the promisee(or).
b. A manifestation of mutual assent.
c. Genuineness of assent.
d. Substantially equal economic benefits to both parties.

M89#24. Dye sent Hill a written offer to sell a tract of land located in Newtown for $60,000. The parties were engaged in a separate dispute. The offer stated that it would be irrevocable for 60 days if Hill would promise to refrain from suing Dye during this time. Hill promptly delivered a promise not to sue during the term of the offer and to forego suit if Hill accepted the offer. Dye subsequently decided that the possible suit by Hill was groundless and therefore phoned Hill and revoked the offer 15 days after making it. Hill mailed an acceptance on the 20th day. Dye did not reply. Under the circumstances,

a. Dye's offer was supported by consideration and was **not** revocable when accepted.
b. Dye's written offer would be irrevocable even without consideration.
c. Dye's silence was an acceptance of Hill's promise.
d. Dye's revocation, **not** being in writing, was invalid.

M88#18. In deciding whether consideration necessary to form a contract exists, a court must determine whether

a. The consideration given by each party is of roughly equal value.
b. There is mutuality of consideration.
c. The consideration has sufficient monetary value.
d. The consideration conforms to the subjective intent of the parties.

C. Capacity, Legality, and Public Policy

M92#25. West, an Indiana real estate broker, misrepresented to Zimmer that West was licensed in Kansas under the Kansas statute that regulates real estate brokers and requires all brokers to be licensed. Zimmer signed a contract agreeing to pay West a 5% commission for selling Zimmer's home in Kansas. West did not sign the contract. West sold Zimmer's home. If West sued Zimmer for nonpayment of commission, Zimmer would be

a. Liable to West only for the value of services rendered.
b. Liable to West for the full commission.
c. Not liable to West for any amount because West did **not** sign the contract.
d. Not liable to West for any amount because West violated the Kansas licensing requirements.

M91#13. On reaching majority, a minor may ratify a contract in any of the following ways **except** by

a. Failing to disaffirm within a reasonable time after reaching majority.
b. Orally ratifying the entire contract.
c. Acting in a manner that amounts to ratification.
d. Affirming, in writing, some of the terms of the contract.

N90#22. Which of the following would be unenforceable because the subject matter is illegal?

a. A contingent fee charged by an attorney to represent a plaintiff in a negligence action.
b. An arbitration clause in a supply contract.
c. A restrictive covenant in an employment contract prohibiting a former employee from using the employer's trade secrets.
d. An employer's promise **not** to press embezzlement charges against an employee who agrees to make restitution.

M90#17. Payne entered into a written agreement to sell a parcel of land to Stevens. At the time the agreement was executed, Payne had consumed alcoholic beverages. Payne's ability to understand the nature and terms of the contract was not impaired. Stevens did not believe that Payne was intoxicated. The contract is

a. Void as a matter of law.
b. Legally binding on both parties.
c. Voidable at Payne's option.
d. Voidable at Stevens' option.

N89#11. Kent, a 16-year old, purchased a used car from Mint Motors, Inc. Ten months later, the car was stolen and never recovered. Which of the following statements is correct?

a. The car's theft is a *de facto* ratification of the purchase because it is impossible to return the car.
b. Kent may disaffirm the purchase because Kent is a minor.
c. Kent effectively ratified the purchase because Kent used the car for an unreasonable period of time.
d. Kent may disaffirm the purchase because Mint, a merchant, is subject to the UCC.

M89#26. Tell, an Ohio real estate broker, misrepresented to Allen that Tell was licensed in Michigan under Michigan's statute regulating real estate brokers. Allen signed a standard form listing contract agreeing to pay Tell a 6% commission for selling Allen's home in Michigan. Tell sold Allen's home. Under the circumstances, Allen is

a. Not liable to Tell for any amount because Allen signed a standard form contract.
b. Not liable to Tell for any amount because Tell violated the Michigan licensing requirements.
c. Liable to Tell only for the value of services rendered under a quasi-contract theory.
d. Liable to Tell for the full commission under a promissory estoppel theory.

N88#13. Parr is the vice-president of research of Lynx, Inc. When hired, Parr signed an employment contract prohibiting Parr from competing with Lynx during and after employment. While employed, Parr acquired knowledge of many of Lynx's trade secrets. If Parr wishes to compete with Lynx and Lynx refuses to give Parr permission, which of the following statements is correct?

a. Parr has the right to compete with Lynx upon resigning from Lynx.
b. Parr has the right to compete with Lynx only if fired from Lynx.
c. In determining whether Parr may compete with Lynx, the court should **not** consider Parr's ability to obtain other employment.
d. In determining whether Parr may compete with Lynx, the court should consider, among other factors, whether the agreement is necessary to protect Lynx's legitimate business interests.

M88#19. Parr is a CPA licensed to practice in State A. Parr entered into a contract with Jet, Inc., to perform an audit in State B for $50,000 (including expenses). After Parr had satisfactorily performed the audit, Jet discovered that Parr had violated State B's licensing statute by failing to obtain a CPA license in State B. Parr incurred $10,000 in expenses in connection with the audit. Jet refuses to pay any fee to Parr, arguing that it could have engaged a local CPA licensed in State B to perform the same services for $35,000 (including expenses). If Parr sues Jet based on breach of contract, Parr will be entitled to recover a maximum of

a. $0
b. $10,000
c. $35,000
d. $50,000

D. Statute of Frauds

M92#26. Carson agreed orally to repair Ives' rare book for $450. Before the work was started, Ives asked Carson to perform additional repairs to the book and agreed to increase the contract price to $650. After Carson completed the work, Ives refused to pay and Carson sued. Ives' defense was based on the Statute of Frauds. What total amount will Carson recover?

a. $0
b. $200
c. $450
d. $650

M91#14. Nolan agreed orally with Train to sell Train a house for $100,000. Train sent Nolan a signed agreement and a down payment of $10,000. Nolan did not sign the agreement, but allowed Train to move into the house. Before closing, Nolan refused to go through with the sale. Train sued Nolan to compel specific performance. Under the provisions of the Statute of Frauds,

a. Train will win because Train signed the agreement and Nolan did **not** object.
b. Train will win because Train made a down payment and took possession.
c. Nolan will win because Nolan did **not** sign the agreement.
d. Nolan will win because the house was worth more than $500.

M91#17. Bond and Spear orally agreed that Bond would buy a car from Spear for $475. Bond paid Spear a $100 deposit. The next day, Spear received an offer of $575, the car's fair market value. Spear immediately notified Bond that Spear would not sell the car to Bond and returned Bond's $100. If Bond sues Spear and Spear defends on the basis of the statute of frauds, Bond will probably

a. Lose, because the agreement was for less than the fair market value of the car.
b. Win, because the agreement was for less than $500.
c. Lose, because the agreement was **not** in writing and signed by Spear.
d. Win, because Bond paid a deposit.

M90#15. King sent Foster, a real estate developer, a signed offer to sell a specified parcel of land to Foster for $200,000. King, an engineer, had inherited the land. On the same day that King's letter was received, Foster telephoned King and accepted the offer. Which of the following statements is correct under the Statute of Frauds?

a. No contract was formed because Foster did **not** sign the offer.
b. No contract was formed because King is **not** a merchant and, therefore, King's letter is **not** binding on Foster.
c. A contract was formed, although it would be enforceable only against King.
d. A contract was formed and would be enforceable against both King and Foster because Foster is a merchant.

M90#20. With regard to an agreement for the sale of real estate, the Statute of Frauds

a. Does **not** require that the agreement be signed by all parties.
b. Does **not** apply if the value of the real estate is less than $500.
c. Requires that the entire agreement be in a single writing.
d. Requires that the purchase price be fair and adequate in relation to the value of the real estate.

N89#12. The Statute of Frauds

a. Prevents the use of oral evidence to contradict the terms of a written contract.
b. Applies to all contracts having consideration valued at $500 or more.
c. Requires the independent promise to pay the debt of another to be in writing.
d. Applies to all real estate leases.

M89#27. Able hired Carr to restore Able's antique car for $800. The terms of their oral agreement provided that Carr was to complete the work within 18 months. Actually, the work could be completed within one year. The agreement is

a. Unenforceable because it covers services with a value in excess of $500.
b. Unenforceable because it covers a time period in excess of one year.
c. Enforceable because personal service contracts are exempt from the Statute of Frauds.
d. Enforceable because the work could be completed within one year.

M89#29. To satisfy the UCC Statute of Frauds, a written agreement for the sale of goods must

a. Contain payment terms.
b. Be signed by both buyer and seller.
c. Indicate that a contract for sale has been made.
d. Refer to the time and place of delivery.

N88#14. Payne borrowed $500 from Onest Bank. At the time the loan was made to Payne, Gem orally agreed with Onest that Gem would repay the loan if Payne failed to do so. Gem received no personal benefit as a result of the loan to Payne. Under the circumstances,

a. Gem is secondarily liable to repay the loan.
b. Both Gem and Payne are primarily liable to repay the loan.
c. Gem is free from liability concerning the loan.
d. Gem is primarily liable to repay the loan.

M88#20. On May 1, Dix and Wilk entered into an oral agreement by which Dix agreed to purchase a small parcel of land from Wilk for $450. Dix paid Wilk $100 as a deposit. The following day, Wilk received another offer to purchase the land for $650, the fair market value. Wilk immediately notified Dix that Wilk would not sell the land for $450. If Dix sues Wilk for specific performance, Dix will

a. Prevail, because the amount of the contract was less than $500.
b. Prevail, because there was part performance.
c. Lose, because the fair market value of the land is over $500.
d. Lose, because the agreement was **not** in writing and signed by Wilk.

E. Statute of Limitations

M92#27. In an action for breach of contract, the statute of limitations time period would be computed from the date of the
a. Breach of the contract.
b. Signing of the contract.
c. Negotiation of the contract.
d. Commencement of the action.

M91#15. In 1959, Dart bought an office building from Graco under a written contract signed only by Dart. In 1991, Dart discovered that Graco made certain false representations during their negotiations concerning the building's foundation. Dart could have reasonably discovered the foundation problems by 1965. Dart sued Graco claiming fraud in the formation of the contract. Which of the following statements is correct?
a. The parol evidence rule will prevent the admission into evidence of proof concerning Dart's allegations.
b. Dart will be able to rescind the contract because both parties did **not** sign it.
c. Dart must prove that the alleged misrepresentations were part of the written contract because the contract involved real estate.
d. The statute of limitations would likely prevent Dart from prevailing because of the length of time that has passed.

N89#13. Unless the parties have otherwise agreed, an action for the breach of a contract within the UCC Sales Article must be commenced within
a. Four years after the cause of action has accrued.
b. Six years after the cause of action has accrued.
c. Four years after the effective date of the contract.
d. Six years after the effective date of the contract.

M88#22. On May 1, 1972, Mix, CPA, entered into an oral contract with Dell to provide certain accounting services to Dell. The contract was fully performed by both parties in 1974. On April 25, 1988, Dell commenced a breach of contract action against Mix claiming that Mix had improperly performed the accounting services. Mix's best defense to the action would likely be the
a. Parol evidence rule.
b. Statute of limitations.
c. Statute of frauds.
d. Lack of consideration.

F. Fraud, Duress, and Undue Influence

M92#28. Which of the following, if intentionally misstated by a seller to a buyer, would be considered a fraudulent inducement to make a contract?
a. Nonexpert opinion.
b. Appraised value.
c. Prediction.
d. Immaterial fact.

N91#21. The intent, or scienter, element necessary to establish a cause of action for fraud will be met if the plaintiff can show that the
a. Defendant made a misrepresentation with a reckless disregard for the truth.
b. Defendant made a false representation of fact.
c. Plaintiff actually relied on the defendant's misrepresentation.
d. Plaintiff justifiably relied on the defendant's misrepresentation.

N91#22. Under the UCC Sales Article, a plaintiff who proves fraud in the formation of a contract may
a. Elect to rescind the contract and need **not** return the consideration received from the other party.
b. Be entitled to rescind the contract and sue for damages resulting from the fraud.
c. Be entitled to punitive damages provided physical injuries resulted from the fraud.
d. Rescind the contract even if there was **no** reliance on the fraudulent statement.

M91#20. Johns leased an apartment from Olsen. Shortly before the lease expired, Olsen threatened Johns with eviction and physical harm if Johns did not sign a new lease for twice the old rent. Johns, unable to afford the expense to fight eviction, and in fear of physical harm, signed the new lease. Three months later, Johns moved and sued to void the lease claiming duress. The lease will be held
a. Void because of the unreasonable increase in rent.
b. Voidable because of Olsen's threat to bring eviction proceedings.
c. Void because of Johns' financial condition.
d. Voidable because of Olsen's threat of physical harm.

N90#23. For a purchaser of land to avoid a contract with the seller based on duress, it must be shown that the seller's improper threats
a. Constituted a crime or tort.
b. Would have induced a reasonably prudent person to assent to the contract.
c. Actually induced the purchaser to assent to the contract.
d. Were made with the intent to influence the purchaser.

M90#21. Steele, Inc. wanted to purchase Kalp's distribution business. On March 15, 1990, Kalp provided Steele with copies of audited financial statements for the period ended December 31, 1989. The financial statements reflected inventory in the amount of $1,200,000. On March 29, 1990, Kalp discovered that the December 31 inventory was overstated by at least $400,000. On April 3, 1990, Steele, relying on the financial statements, purchased all of Kalp's business.

On April 29, 1990, Steele discovered the inventory overstatement. Steele sued Kalp for fraud. Which of the following statements is correct?

a. Steele will lose because it should **not** have relied on the inventory valuation in the financial statements.
b. Steele will lose because Kalp was unaware that the inventory valuation was incorrect at the time the financial statements were provided to Steele.
c. Steele will prevail because Kalp had a duty to disclose the fact that the inventory value was overstated.
d. Steele will prevail but will **not** be able to sue for damages.

N89#14. Bradford sold a parcel of land to Jones who promptly recorded the deed. Bradford then resold the land to Wallace. In a suit against Bradford by Wallace, recovery will be based on the theory of

a. Bilateral mistake.
b. Ignorance of the facts.
c. Unilateral mistake.
d. Fraud.

M89#28. King had several outstanding unsecured loans with National Bank. In addition, King had a separate loan with National that was secured by a mortgage on a farm owned by King. King was delinquent on the mortgage loan but not on the unsecured loans. National asked King to sign renewal notes for the unsecured loans at substantially higher interest rates. When King refused, National informed King that it would foreclose on the farm's mortgage if King did not sign. King signed but later disaffirmed the new unsecured notes and National sued. King's best defense is

a. Undue influence.
b. Unconscionability.
c. Duress.
d. Fraud in the inducement.

M88#25. To establish a cause of action based on fraud in the inducement, one of the elements the plaintiff must generally prove is that

a. It is impossible for the plaintiff to perform the terms of the contract.
b. The contract is unconscionable.
c. The defendant made a false representation of a material fact.
d. There has been a mutual mistake of a material fact by the plaintiff and defendant.

G. Mistake and Misrepresentation

M92#29. If a buyer accepts an offer containing an immaterial unilateral mistake, the resulting contract will be

a. Void as a matter of law.
b. Void at the election of the buyer.
c. Valid as to both parties.
d. Voidable at the election of the seller.

M91#21. To prevail in a common law action for innocent misrepresentation, the plaintiff must prove

a. The defendant made the false statements with a reckless disregard for the truth.
b. The misrepresentations were in writing.
c. The misrepresentations concerned material facts.
d. Reliance on the misrepresentations was the only factor inducing the plaintiff to enter into the contract.

M90#23. Paco Corp., a building contractor, offered to sell Preston several pieces of used construction equipment. Preston was engaged in the business of buying and selling equipment. Paco's written offer had been prepared by a secretary who typed the total price as $10,900, rather than $109,000, which was the approximate fair market value of the equipment. Preston, on receipt of the offer, immediately accepted it. Paco learned of the error in the offer and refused to deliver the equipment to Preston unless Preston agreed to pay $109,000. Preston has sued Paco for breach of contract. Which of the following statements is correct?

a. Paco will **not** be liable because there has been a mutual mistake of fact.
b. Paco will be able to rescind the contract because Preston should have known that the price was erroneous.
c. Preston will prevail because Paco is a merchant.
d. The contract between Paco and Preston is void because the price set forth in the offer is substantially less than the equipment's fair market value.

N89#15. A party to a contract who seeks to rescind the contract because of that party's reliance on the unintentional but materially false statements of the other party will assert

a. Reformation.
b. Actual fraud.
c. Misrepresentation.
d. Constructive fraud.

M89#30. Which of the following remedies is available to a party who has entered into a contract in reliance upon the other contracting party's innocent misrepresentations as to material facts?

	Compensatory damages	*Punitive damages*	*Rescission*
a.	No	No	No
b.	Yes	No	Yes
c.	No	No	Yes
d.	Yes	Yes	No

N88#16. On April 6, Apple entered into a signed contract with Bean, by which Apple was to sell Bean an antique automobile having a fair market value of $150,000, for $75,000. Apple believed the auto was worth only $75,000. Unknown to either party the auto had been destroyed by fire on April 4. If Bean sues Apple for breach of contract, Apple's best defense is

a. Unconscionability.
b. Risk of loss had passed to Bean.
c. Lack of adequate consideration.
d. Mutual mistake.

H. Parol Evidence Rule

M92#30. Under the parol evidence rule, oral evidence will be excluded if it relates to

a. A contemporaneous oral agreement relating to a term in the contract.
b. Failure of a condition precedent.
c. Lack of contractual capacity.
d. A modification made several days after the contract was executed.

N91#23. Two individuals signed a contract that was intended to be their entire agreement. The parol evidence rule will prevent the admission of evidence offered to

a. Explain the meaning of an ambiguity in the written contract.
b. Establish that fraud had been committed in the formation of the contract.
c. Prove the existence of a contemporaneous oral agreement modifying the contract.
d. Prove the existence of a subsequent oral agreement modifying the contract.

M91#18. Dunne and Cook signed a contract requiring Cook to rebind 500 of Dunne's books at 80¢ per book. Later, Dunne requested, in good faith, that the price be reduced to 70¢ per book. Cook agreed orally to reduce the price to 70¢. Under the circumstances, the oral agreement is

a. Enforceable, but proof of it is inadmissible into evidence.
b. Enforceable, and proof of it is admissible into evidence.
c. Unenforceable, because Dunne failed to give consideration, but proof of it is otherwise admissible into evidence.
d. Unenforceable, due to the statute of frauds, and proof of it is inadmissible into evidence.

N89#16. Ward is attempting to introduce oral evidence in an action relating to a written contract between Ward and Weaver. Weaver has pleaded the parol evidence rule. Ward will be prohibited from introducing parol evidence if it relates to

a. A modification made several days after the contract was executed.
b. A change in the meaning of an unambiguous provision in the contract.
c. Fraud in the inducement.
d. An obvious error in drafting.

M88#21. Baker and Able signed a contract which required Able to purchase 600 books from Baker at 90¢ per book. Subsequently, Able, in good faith, requested that the price of the books be reduced to 80¢ per book. Baker orally agreed to reduce the price to 80¢. Under the circumstances, the oral agreement is

a. Unenforceable, because Able failed to give consideration, but proof of it will be otherwise admissible into evidence.
b. Unenforceable, due to the statute of frauds, and proof of it will be inadmissible into evidence.
c. Enforceable, but proof of it will be inadmissible into evidence.
d. Enforceable, and proof of it will be admissible into evidence.

I. Third Party Rights

M92#33. Egan contracted with Barton to buy Barton's business. The contract provided that Egan would pay the business debts Barton owed Ness and that the balance of the purchase price would be paid to Barton over a 10 year period. The contract also required Egan to take out a decreasing term life insurance policy naming Barton and Ness as beneficiaries to ensure that the amounts owed Barton and Ness would be paid if Egan died.

Which of the following would describe Ness' status under the contract and insurance policy?

	Contract	*Insurance policy*
a.	Donee beneficiary	Donee beneficiary
b.	Donee beneficiary	Creditor beneficiary
c.	Creditor beneficiary	Donee beneficiary
d.	Creditor beneficiary	Creditor beneficiary

M91#19. Wilk bought an apartment building from Dix Corp. There was a mortgage on the building securing Dix's promissory note to Xeon Finance Co. Wilk took title subject to Xeon's mortgage. Wilk did not make the payments on the note due Xeon and the building was sold at a foreclosure sale. If the proceeds of the foreclosure sale are less than the balance due on the note, which of the following statements is correct regarding the deficiency?

a. Xeon must attempt to collect the deficiency from Wilk before suing Dix.
b. Dix will **not** be liable for any of the deficiency because Wilk assumed the note and mortgage.
c. Xeon may collect the deficiency from either Dix or Wilk.
d. Dix will be liable for the entire deficiency.

M91#22. Graham contracted with the city of Harris to train and employ high school dropouts residing in Harris. Graham breached the contract. Long, a resident of Harris and a high school dropout, sued Graham for damages. Under the circumstances, Long will

a. Win, because Long is a third-party beneficiary entitled to enforce the contract.
b. Win, because the intent of the contract was to confer a benefit on all high school dropouts residing in Harris.
c. Lose, because Long is merely an incidental beneficiary of the contract.
d. Lose, because Harris did **not** assign its contract rights to Long.

M90#24. Omega Corp. owned a factory that was encumbered by a mortgage securing Omega's note to Eagle Bank. Omega sold the factory to Spear, Inc., which assumed the mortgage note. Later, Spear defaulted on the note, which had an outstanding balance of $15,000. To recover the outstanding balance, Eagle

a. May sue Spear only after suing Omega.
b. May sue either Spear or Omega.
c. Must sue both Spear and Omega.
d. Must sue Spear first and then proceed against Omega for any deficiency.

M90#19. Union Bank lent $200,000 to Wagner. Union required Wagner to obtain a life insurance policy naming Union as beneficiary. While the loan was outstanding, Wagner stopped paying the premiums on the policy. Union paid the premiums, adding the amounts paid to Wagner's loan. Wagner died and the insurance company refused to pay the policy proceeds to Union. Union may

a. Recover the policy proceeds because it is a creditor beneficiary.
b. Recover the policy proceeds because it is a donee beneficiary.
c. Not recover the policy proceeds because it is **not** in privity of contract with the insurance company.
d. Not recover the policy proceeds because it is only an incidental beneficiary.

M90#24. Rice contracted with Locke to build an oil refinery for Locke. The contract provided that Rice was to use United pipe fittings. Rice did not do so. United learned of the contract and, anticipating the order, manufactured additional fittings. United sued Locke and Rice. United is

a. Entitled to recover from Rice only, because Rice breached the contract.
b. Entitled to recover from either Locke or Rice because it detrimentally relied on the contract.
c. Not entitled to recover because it is a donee beneficiary.
d. Not entitled to recover because it is an incidental beneficiary.

N89#17. Jones owned an insurance policy on her life, on which she paid all the premiums. Smith was named the beneficiary. Jones died and the insurance company refused to pay the insurance proceeds to Smith. An action by Smith against the insurance company for the insurance proceeds will be

a. Successful because Smith is a third party donee beneficiary.
b. Successful because Smith is a proper assignee of Jones' rights under the insurance policy.
c. Unsuccessful because Smith was **not** the owner of the policy.
d. Unsuccessful because Smith did **not** pay any of the premiums.

M89#32. Ace contracted with Big City to train and employ handicapped, unemployed veterans residing in Big City. Ace breached the contract and Bell, a resident of Big City who is a handicapped, unemployed veteran, sues Ace for damages. Under the circumstances, Bell will

a. Lose, because Bell is merely an incidental beneficiary of the contract.
b. Win, because Bell is a third-party beneficiary entitled to enforce the contract.
c. Lose, because Big City did **not** assign its contract rights to Bell.
d. Win, because the intent of the contract was to confer a benefit on all handicapped, unemployed veterans residing in Big City.

N88#17. Bond purchased from Spear Corp. an apartment building that was encumbered by a mortgage securing Spear's promissory note to Fale Finance Co. Bond assumed Spear's note and mortgage. Subsequently, Bond defaulted on the note payable to Fale and, as a result, the building was sold at a foreclosure sale. If the proceeds of the foreclosure sale are less than the balance due on the note, which of the following statements is correct?

a. Fale must sue both Spear and Bond to collect the deficiency because they are jointly and severally liable.
b. Spear will be liable for the deficiency.
c. Fale must attempt to collect the deficiency from Bond before suing Spear.
d. Spear will **not** be liable for the deficiency because Bond assumed the note and mortgage.

J. Assignments

M92#31. Baxter Inc. and Globe entered into a contract. After receiving valuable consideration from Clay, Baxter assigned its rights under the contract to Clay. In which of the following circumstances would Baxter **not** be liable to Clay?

a. Clay released Globe.
b. Globe paid Baxter.
c. Baxter released Globe.
d. Baxter breached the contract.

M92#34. Egan contracted with Barton to buy Barton's business. The contract provided that Egan would pay the business debts Barton owed Ness and that the balance of the purchase price would be paid to Barton over a 10 year period. The contract also required Egan to take out a decreasing term life insurance policy naming Barton and Ness as beneficiaries to ensure that the amounts owed Barton and Ness would be paid if Egan died.

Barton's contract rights were assigned to Vim, and Egan was notified of the assignment. Despite the assignment, Egan continued making payments to Barton. Egan died before completing payment and Vim sued Barton for the insurance proceeds and the other payments on the purchase price received by Barton after the assignment. To which of the following is Vim entitled?

	Payments on purchase price	*Insurance proceeds*
a.	No	Yes
b.	No	No
c.	Yes	Yes
d.	Yes	No

N91#24. Yost contracted with Egan for Yost to buy certain real property. If the contract is otherwise silent, Yost's rights under the contract are

a. Assignable only with Egan's consent.
b. Nonassignable because they are personal to Yost.
c. Nonassignable as a matter of law.
d. Generally assignable.

M91#28. One of the criteria for a valid assignment of a sales contract to a third party is that the assignment must

a. Not materially increase the other party's risk or duty.
b. Not be revocable by the assignor.
c. Be supported by adequate consideration from the assignee.
d. Be in writing and signed by the assignor.

M90#22. On August 1, Neptune Fisheries contracted in writing with West Markets to deliver to West 3,000 pounds of lobsters at $4.00 a pound. Delivery of the lobsters was due October 1 with payment due November 1. On August 4, Neptune entered into a contract with Deep Sea Lobster Farms which provided as follows: "Neptune Fisheries assigns all the rights under the contract with West Markets dated August 1 to Deep Sea Lobster Farms." The best interpretation of the August 4 contract would be that it was

a. Only an assignment of rights by Neptune.
b. Only a delegation of duties by Neptune.
c. An assignment of rights and a delegation of duties by Neptune.
d. An unenforceable third-party beneficiary contract.

N89#18. Moss entered into a contract to purchase certain real property from Shinn. Which of the following statements is **not** correct?

a. If Shinn fails to perform the contract, Moss can obtain specific performance.
b. The contract is nonassignable as a matter of law.
c. The Statute of Frauds applies to the contract.
d. Any amendment to the contract must be agreed to by both Moss and Shinn.

M89#33. Generally, which one of the following transfers will be valid without the consent of the other parties?

a. The assignment by the lessee of a lease contract where rent is a percentage of sales.
b. The assignment by a purchaser of goods of the right to buy on credit without giving security.
c. The assignment by an architect of a contract to design a building.
d. The assignment by a patent holder of the right to receive royalties.

N88#18. Pix borrowed $80,000 from Null Bank. Pix gave Null a promissory note and mortgage. Subsequently, Null assigned the note and mortgage to Reed. Reed failed to record the assignment or notify Pix of the assignment. If Pix pays Null pursuant to the note, Pix will

a. Be primarily liable to Reed for the payments made to Null.
b. Be secondarily liable to Reed for the payments made to Null.
c. Not be liable to Reed for the payments made to Null because Reed failed to record the assignment.
d. Not be liable to Reed for the payments made to Null because Reed failed to give Pix notice of the assignment.

M88#23. Quick Corp. has $270,000 of outstanding accounts receivable. On March 10, 1988, Quick assigned a $30,000 account receivable due from Pine, one of Quick's customers, to Taft Bank for value. On March 30, Pine paid Quick the $30,000. On April 5, Taft notified Pine of the March 10 assignment from Quick to Taft. Taft is entitled to collect $30,000 from

a. Either Quick or Pine.
b. Neither Quick nor Pine.
c. Pine only.
d. Quick only.

K. Discharge, Breach, and Remedies

M92#32. To cancel a contract and to restore the parties to their original positions before the contract, the parties should execute a

a. Novation
b. Release
c. Rescission
d. Revocation

M92#35. Kaye contracted to sell Hodges a building for $310,000. The contract required Hodges to pay the entire amount at closing. Kaye refused to close the sale of the building. Hodges sued Kaye. To what relief is Hodges entitled?

a. Punitive damages and compensatory damages.
b. Specific performance and compensatory damages.
c. Consequential damages or punitive damages.
d. Compensatory damages or specific performance.

N91#25. On May 25, 1991, Smith contracted with Jackson to repair Smith's cabin cruiser. The work was to begin on May 31, 1991. On May 26, 1991, the boat, while docked at Smith's pier, was destroyed by arson. Which of the following statements is correct with regard to the contract?

a. Smith would **not** be liable to Jackson because of mutual mistake.
b. Smith would be liable to Jackson for the profit Jackson would have made under the contract.
c. Jackson would **not** be liable to Smith because performance by the parties would be impossible.
d. Jackson would be liable to repair another boat owned by Smith.

M91#23. Maco Corp. contracted to sell 1,500 bushels of potatoes to LBC Chips. The contract did not refer to any specific supply source for the potatoes. Maco intended to deliver potatoes grown on its farms. An insect infestation ruined Maco's crop but not the crops of other growers in the area. Maco failed to deliver the potatoes to LBC. LBC sued Maco for breach of contract. Under the circumstances, Maco will

a. Lose, because it could have purchased potatoes from other growers to deliver to LBC.
b. Lose, unless it can show that the purchase of substitute potatoes for delivery to LBC would make the contract unprofitable.
c. Win, because the infestation was an act of nature that could **not** have been anticipated by Maco.
d. Win, because both Maco and LBC are assumed to accept the risk of a crop failure.

M91#24. In general, a clause in a real estate contract entitling the seller to retain the purchaser's down payment as liquidated damages if the purchaser fails to close the transaction, is enforceable

a. In all cases, when the parties have a signed contract.
b. If the amount of the down payment bears a reasonable relationship to the probable loss.
c. As a penalty, if the purchaser intentionally defaults.
d. Only when the seller cannot compel specific performance.

N90#25. Parc hired Glaze to remodel and furnish an office suite. Glaze submitted plans that Parc approved. After completing all the necessary construction and painting, Glaze purchased minor accessories that Parc rejected because they did not conform to the plans. Parc refused to allow Glaze to complete the project and refused to pay Glaze any part of the contract price. Glaze sued for the value of the work performed. Which of the following statements is correct?

a. Glaze will lose because Glaze breached the contract by **not** completing performance.
b. Glaze will win because Glaze substantially performed and Parc prevented complete performance.
c. Glaze will lose because Glaze materially breached the contract by buying the accessories.
d. Glaze will win because Parc committed anticipatory breach.

M90#25. Wren purchased a factory from First Federal Realty. Wren paid 20% at the closing and gave a note for the balance secured by a 20-year mortgage. Five years later, Wren found it increasingly difficult to make payments on the note and defaulted. First Federal threatened to accelerate the loan and foreclose if Wren continued in default. First Federal told Wren to make payment or obtain an acceptable third party to assume the obligation. Wren offered the land to Moss, Inc. for $10,000 less than the equity Wren had in the property. This was acceptable to First Federal and at the closing Moss paid the arrearage, assumed the mortgage and note, and had title transferred to its name. First Federal released Wren. The transaction in question is a(an)

a. Purchase of land subject to a mortgage.
b. Assignment and delegation.
c. Third party beneficiary contract.
d. Novation.

N89#19. Nagel and Fields entered into a contract in which Nagel was obligated to deliver certain goods to Fields by September 10. On September 3, Nagel told Fields that Nagel had no intention of delivering the goods required by the contract. Prior to September 10, Fields may successfully sue Nagel under the doctrine of

a. Promissory estoppel.
b. Accord and satisfaction.
c. Anticipatory repudiation.
d. Substantial performance.

M89#34. In September 1988, Cobb Company contracted with Thrifty Oil Company for the delivery of 100,000 gallons of heating oil at the price of 75¢ per gallon at regular specified intervals during the forthcoming winter. Due to an unseasonably warm winter, Cobb took delivery on only 70,000 gallons. In a suit against Cobb for breach of contract, Thrifty will

a. Lose, because Cobb acted in good faith.
b. Lose, because both parties are merchants and the UCC recognizes commercial impracticability.
c. Win, because this is a requirements contract.
d. Win, because the change of circumstances could have been contemplated by the parties.

M89#35. Jones, CPA, entered into a signed contract with Foster Corp. to perform accounting and review services. If Jones repudiates the contract prior to the date performance is due to begin, which of the following is **not** correct?

a. Foster could successfully maintain an action for breach of contract after the date performance was due to begin.
b. Foster can obtain a judgment ordering Jones to perform.
c. Foster could successfully maintain an action for breach of contract prior to the date performance is due to begin.
d. Foster can obtain a judgment for the monetary damages it incurred as a result of the repudiation.

N88#19. Foster Co. and Rice executed a contract by which Foster was to sell a warehouse to Rice for $270,000. The contract required Rice to pay the entire $270,000 at the closing. Foster has refused to close the sale of the warehouse to Rice. If Rice commences a lawsuit against Foster, what relief would Rice likely be entitled to?

a. Specific performance or compensatory damages.
b. Specific performance and compensatory damages.
c. Compensatory damages or punitive damages.
d. Compensatory damages and punitive damages.

M88#24. Dell owed Stark $9,000. As the result of an unrelated transaction, Stark owed Ball that same amount. The three parties signed an agreement that Dell would pay Ball instead of Stark, and Stark would be discharged from all liability. The agreement among the parties is

a. A novation.
b. An executed accord and satisfaction.
c. Voidable at Ball's option.
d. Unenforceable for lack of consideration.

IV. Debtor-Creditor Relationships

A. Suretyship

N91#26. Mane Bank lent Eller $120,000 and received securities valued at $30,000 as collateral. At Mane's request, Salem and Rey agreed to act as uncompensated co-sureties on the loan. The agreement provided that Salem's and Rey's maximum liability would be $120,000 each.

Mane released Rey without Salem's consent. Eller later defaulted when the collateral held by Mane was worthless and the loan balance was $90,000. Salem's maximum liability is

a. $30,000
b. $45,000
c. $60,000
d. $90,000

N91#38. Brown was unable to repay a loan from Safe Bank when due. Safe refused to renew the loan unless Brown provided an acceptable surety. Brown asked King, a friend, to act as surety on the loan. To induce King to agree to become a surety, Brown fraudulently represented Brown's financial condition and promised King discounts on merchandise sold at Brown's store. King agreed to act as surety and the loan was renewed. Later, Brown's obligation to Safe was discharged in Brown's bankruptcy. Safe wants to hold King liable. King may avoid liability

a. Because the discharge in bankruptcy will prevent King from having a right of reimbursement.
b. Because the arrangement was void at the inception.
c. If King was an uncompensated surety.
d. If King can show that Safe was aware of the fraudulent representations.

M91#25. Which of the following events will release a noncompensated surety from liability?

a. Filing of an involuntary petition in bankruptcy against the principal debtor.
b. Insanity of the principal debtor at the time the contract was entered into with the creditor.
c. Release of the principal debtor's obligation by the creditor but with the reservation of the creditor's rights against the surety.
d. Modification by the principal debtor and creditor of their contract that materially increases the surety's risk of loss.

M91#26. Edwards Corp. lent Lark $200,000. At Edwards' request, Lark entered into an agreement with Owen and Ward for them to act as compensated co-sureties on the loan in the amount of $200,000 each. If Edwards releases Ward without Owen's or Lark's consent, and Lark later defaults, which of the following statements is correct?

a. Lark will be released for 50% of the loan balance.
b. Owen will be liable for the entire loan balance.
c. Owen will be liable for 50% of the loan balance.
d. Edwards' release of Ward will have **no** effect on Lark's and Owen's liability to Edwards.

M91#27. Lane promised to lend Turner $240,000 if Turner obtained sureties to secure the loan. Turner agreed with Rivers, Clark, and Zane for them to act as cosureties on the loan from Lane. The agreement between Turner and the cosureties provided that compensation be paid to each of the cosureties. It further indicated that the maximum liability of each cosurety would be as follows: Rivers $240,000, Clark $80,000, and Zane $160,000. Lane accepted the commitments of the sureties and made the loan to Turner. After paying ten installments totaling $100,000, Turner defaulted. Clark's debts, including the surety obligation to Lane on the Turner loan, were discharged in bankruptcy. Later, Rivers properly paid the entire outstanding debt of $140,000. What amount may Rivers recover from Zane?

a. $0
b. $56,000
c. $70,000
d. $84,000

N90#26. Sorus and Ace have agreed, in writing, to act as guarantors of collection on a debt owed by Pepper to Towns, Inc. The debt is evidenced by a promissory note. If Pepper defaults, Towns will be entitled to recover from Sorus and Ace unless

a. Sorus and Ace are in the process of exercising their rights against Pepper.
b. Sorus and Ace prove that Pepper was insolvent at the time the note was signed.
c. Pepper dies before the note is due.
d. Towns has **not** attempted to enforce the promissory note against Pepper.

N89#20. Burns borrowed $240,000 from Dollar Bank as additional working capital for his business. Dollar required that the loan be collateralized to the extent of 20%, and that an acceptable surety for the entire amount be obtained. Surety Co. agreed to act as surety on the loan and Burns pledged $48,000 of negotiable bearer bonds. Burns defaulted. Which of the following statements is correct?

a. Dollar must first liquidate the collateral before it can proceed against Surety.
b. Surety is liable in full immediately upon default by Burns, but will be entitled to the collateral upon satisfaction of the debt.
c. Dollar must first proceed against Burns and obtain a judgment before it can proceed against the collateral.
d. Surety may proceed against Burns for the full amount of the loan even if Surety settles with Dollar for a lower amount.

N89#21. If a debtor defaults and the debtor's surety satisfies the obligation, the surety acquires the right of

a. Subrogation.
b. Primary lien.
c. Indemnification.
d. Satisfaction.

N88#21. Ott and Bane agreed to act as co-sureties on an $80,000 loan that Cread Bank made to Dash. Ott and Bane are each liable for the entire $80,000 loan. Subsequently, Cread released Ott from liability without Bane's consent and without reserving its rights against Bane. If Dash subsequently defaults, Cread will be entitled to collect a maximum of

a. $0 from Bane.
b. $0 from Dash.
c. $40,000 from Bane.
d. $40,000 from Dash.

M88#26. Sklar borrowed $360,000 from Rich Bank. At Rich's request, Sklar entered into an agreement with Aker, Burke, and Cey to act as co-sureties on the loan. The agreement between Sklar and the co-sureties provided that the maximum liability of each co-surety was: Aker $72,000, Burke $108,000, and Cey $180,000. After making several payments, Sklar defaulted on the loan. The balance was $240,000. If Cey pays $180,000 and Sklar subsequently pays $60,000, what amounts may Cey recover from Aker and Burke?

a. $0 from Aker and $0 from Burke.
b. $60,000 from Aker and $60,000 from Burke.
c. $48,000 from Aker and $72,000 from Burke.
d. $36,000 from Aker and $54,000 from Burke.

B. Bankruptcy

N91#28. Which of the following statements is correct concerning the voluntary filing of a petition in bankruptcy?

a. If the debtor has 12 or more creditors, the unsecured claims must total at least $5,000.
b. The debtor must be insolvent.
c. If the debtor has less than 12 creditors, the unsecured claims must total at least $5,000.
d. The petition may be filed jointly by spouses.

N91#29. To file for bankruptcy under Chapter 7 of the Federal Bankruptcy Code, an individual must

a. Have debts of any amount.
b. Be insolvent.
c. Be indebted to more than three creditors.
d. Have debts in excess of $5,000.

N91#30. Which of the following claims would have the highest priority in the distribution of a bankruptcy estate under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code if the petition was filed June 1, 1991?

a. Federal tax lien filed May 15, 1991.
b. A secured debt properly perfected on February 10, 1991.
c. Trustee's administration costs filed September 30, 1991.
d. Employee wages due March 30, 1991.

N91#31. By signing a reaffirmation agreement on April 15, 1991, a debtor agreed to pay certain debts that would be discharged in bankruptcy. On June 20, 1991, the debtor's attorney filed the reaffirmation agreement and an affidavit with the court indicating that the debtor understood the consequences of the reaffirmation agreement. The debtor obtained a discharge on August 25, 1991. The reaffirmation agreement would be enforceable only if it was

a. Made after discharge.
b. Approved by the bankruptcy court.
c. Not for a household purpose debt.
d. Not rescinded before discharge.

N91
Items 42 through 45 are based on the following:

On February 28, 1991, Master, Inc. had total assets with a fair market value of $1,200,000 and total liabilities of $990,000. On January 15, 1991, Master made a monthly installment note payment to Acme Distributors Corp., a creditor holding a properly perfected security interest in equipment having a fair market value greater than the balance due on the note. On March 15, 1991, Master voluntarily filed a petition in bankruptcy under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code. One year later, the equipment was sold for less than the balance due on the note to Acme.

42. If a creditor challenged Master's right to file, the petition would be dismissed

a. If Master had less than 12 creditors at the time of filing.
b. Unless Master can show that a reorganization under Chapter 11 of the Federal Bankruptcy Code would have been unsuccessful.
c. Unless Master can show that it is unable to pay its debts in the ordinary course of business or as they come due.
d. If Master is an insurance company.

43. If Master's voluntary petition is filed properly,

a. Master will be entitled to conduct its business as a debtor-in-possession unless the court appoints a trustee.
b. A trustee must be appointed by the creditors.
c. Lawsuits by Master's creditors will be stayed by the Federal Bankruptcy Code.
d. The unsecured creditors must elect a creditors' committee of three to eleven members to consult with the trustee.

44. Master's payment to Acme could

a. Be set aside as a preferential transfer because the fair market value of the collateral was greater than the installment note balance.
b. Be set aside as a preferential transfer unless Acme showed that Master was solvent on January 15, 1991.
c. Not be set aside as a preferential transfer because Acme was oversecured.
d. Not be set aside as a preferential transfer if Acme showed that Master was solvent on March 15, 1991.

45. Which of the following statements correctly describes Acme's distribution from Master's bankruptcy estate?

a. Acme will receive the total amount it is owed, even if the proceeds from the sale of the collateral were less than the balance owed by Master.
b. Acme will have the same priority as unsecured general creditors to the extent that the proceeds from the sale of its collateral are insufficient to satisfy the amount owed by Master.
c. The total proceeds from the sale of the collateral will be paid to Acme even if they are less than the balance owed by Master, provided there is sufficient cash to pay all administrative costs associated with the bankruptcy.
d. Acme will receive only the proceeds from the sale of the collateral in full satisfaction of the debt owed by Master.

M91#29. Unger owes a total of $50,000 to eight unsecured creditors and one fully secured creditor. Quincy is one of the unsecured creditors and is owed $6,000. Quincy has filed a petition against Unger under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code. Unger has been unable to pay debts as they become due. Unger's liabilities exceed Unger's assets. Unger has filed papers opposing the bankruptcy petition. Which of the following statements regarding Quincy's petition is correct?

a. It will be dismissed because the secured creditor failed to join in the filing of the petition.
b. It will be dismissed because three unsecured creditors must join in the filing of the petition.
c. It will be granted because Unger's liabilities exceed Unger's assets.
d. It will be granted because Unger is unable to pay Unger's debts as they become due.

M91#30. A voluntary petition filed under the liquidation provisions of Chapter 7 of the Federal Bankruptcy Code

a. Is **not** available to a corporation unless it has previously filed a petition under the reorganization provisions of Chapter 11 of the Federal Bankruptcy Code.
b. Automatically stays collection actions against the debtor **except** by secured creditors.
c. Will be dismissed unless the debtor has 12 or more unsecured creditors whose claims total at least $5,000.
d. Does **not** require the debtor to show that the debtor's liabilities exceed the fair market value of assets.

M91#31. In general, which of the following debts will be discharged under the voluntary liquidation provisions of Chapter 7 of the Federal Bankruptcy Code?

a. A debt due to the negligence of the debtor arising before filing the bankruptcy petition.
b. Alimony payments owed the debtor's spouse under a separation agreement entered into two years before the filing of the bankruptcy petition.
c. A debt incurred more than 90 days before the filing of the bankruptcy petition and **not** disclosed in the petition.
d. Income taxes due within two years before the filing of the bankruptcy petition.

M91#32. Peters Co. repairs computers. On February 9, 1991, Stark Electronics Corp. sold Peters a circuit tester on credit. Peters executed an installment note for the purchase price, a security agreement covering the tester, and a financing statement that Stark filed on February 11, 1991. On April 13, 1991, creditors other than Stark filed an involuntary petition in bankruptcy against Peters. What is Stark's status in Peters' bankruptcy?

a. Stark will be treated as an unsecured creditor because Stark did **not** join in the filing against Peters.
b. Stark's security interest constitutes a voidable preference because the financing statement was **not** filed until February 11.
c. Stark's security interest constitutes a voidable preference because the financing statement was filed within 90 days before the bankruptcy proceeding was filed.
d. Stark is a secured creditor and can assert a claim to the circuit tester that will be superior to the claims of Peters' other creditors.

M91
Items 33 and 34 are based on the following:

On May 1, 1991, two months after becoming insolvent, Quick Corp., an appliance wholesaler, filed a voluntary petition for bankruptcy under the provisions of Chapter 7 of the Federal Bankruptcy Code. On October 15, 1990, Quick's board of directors had authorized and paid Erly $50,000 to repay Erly's April 1, 1990, loan to the corporation. Erly is a sibling of Quick's president. On March 15, 1991, Quick paid Kray $100,000 for inventory delivered that day.

33. Which of the following is **not** relevant in determining whether the repayment of Erly's loan is a voidable preferential transfer?

a. Erly is an insider.
b. Quick's payment to Erly was made on account of an antecedent debt.
c. Quick's solvency when the loan was made by Erly.
d. Quick's payment to Erly was made within one year of the filing of the bankruptcy petition.

34. Quick's payment to Kray would

a. Not be voidable, because it was a contemporaneous exchange.
b. Not be voidable, unless Kray knew about Quick's insolvency.
c. Be voidable, because it was made within 90 days of the bankruptcy filing.
d. Be voidable, because it enabled Kray to receive more than it otherwise would receive from the bankruptcy estate.

M91#35. Decal Corp. incurred substantial operating losses for the past three years. Unable to meet its current obligations, Decal filed a petition for reorganization under Chapter 11 of the Federal Bankruptcy Code. Which of the following statements is correct?

a. A creditors' committee, if appointed, will consist of unsecured creditors.
b. The court must appoint a trustee to manage Decal's affairs.
c. Decal may continue in business only with the approval of a trustee.
d. The creditors' committee must select a trustee to manage Decal's affairs.

N90#27. On June 5, 1989, Gold rented equipment under a four-year lease. On March 8, 1990, Gold was petitioned involuntarily into bankruptcy under the Federal Bankruptcy Code's liquidation provisions. A trustee was appointed. The fair market value of the equipment exceeds the balance of the lease payments due. The trustee

a. May **not** reject the equipment lease because the fair market value of the equipment exceeds the balance of the lease payments due.
b. May elect **not** to assume the equipment lease.
c. Must assume the equipment lease because its term exceeds one year.
d. Must assume and subsequently assign the equipment lease.

N90#28. Flax, a sole proprietor, has been petitioned involuntarily into bankruptcy under the Federal Bankruptcy Code's liquidation provisions. Simon & Co., CPAs, has been appointed trustee of the bankruptcy estate. If Simon also wishes to act as the tax return preparer for the estate, which of the following statements is correct?

a. Simon is prohibited from serving as both trustee and preparer under any circumstances because serving in that dual capacity would be a conflict of interest.
b. Although Simon may serve as both trustee and preparer, it is entitled to receive a fee only for the services rendered as a preparer.
c. Simon may employ itself to prepare tax returns if authorized by the court and may receive a separate fee for services rendered in each capacity.
d. Although Simon may serve as both trustee and preparer, its fee for services rendered in each capacity will be determined solely by the size of the estate.

N90#29. A contested involuntary petition in bankruptcy will be dismissed if the debtor

a. Owes unsecured obligations exceeding $5,000 to less than three creditors.
b. Had all its property taken to enforce a lien within 120 days of filing.
c. Is failing to pay undisputed debts as they become due.
d. Is an individual engaged in the business of farming.

N90#30. Larson, an unemployed carpenter, filed for voluntary bankruptcy on August 14, 1990. Larson's liabilities are listed below.

Credit card charges due May 2, 1989	$3,000
Bank loan incurred June 1990	5,000
Medical expenses incurred June 1983	7,000
Alimony due during 1988	1,000

Under the provisions of Chapter 7 of the Federal Bankruptcy Code, Larson's discharge will **not** apply to the unpaid

a. Credit card charges.
b. Bank loan.
c. Medical expenses.
d. Alimony.

N90#31. In a voluntary bankruptcy proceeding under Chapter 7 of the Federal Bankruptcy Code, which of the following claims incurred within 180 days prior to filing will be paid first?

a. Unsecured federal taxes.
b. Utility bills up to $1,000.
c. Voluntary contributions to employee benefit plans.
d. Employee vacation and sick pay up to $2,000 per employee.

N90#32. Chapter 7 of the Federal Bankruptcy Code will deny a debtor a discharge when the debtor

a. Made a preferential transfer to a creditor.
b. Accidentally destroyed information relevant to the bankruptcy proceeding.
c. Obtained a Chapter 7 discharge 10 years previously.
d. Is a corporation or a partnership.

N90#33. A claim will **not** be discharged in a bankruptcy proceeding if it

a. Is brought by a secured creditor and remains unsatisfied after receipt of the proceeds from the disposition of the collateral.
b. Is for unintentional torts that resulted in bodily injury to the claimant.
c. Arises from an extension of credit based upon false representations.
d. Arises out of the breach of a contract by the debtor.

N90#34. On May 24, Knurl, an appliance dealer, filed for bankruptcy under the provisions of Chapter 7 of the Federal Bankruptcy Code. A trustee was appointed and an order for relief was entered. Knurl's nonexempt property was converted to cash, which is available to satisfy the following claims and expenses:

Claim by Card Corp. (one of Knurl's suppliers) for toasters ordered on May 11, and delivered on credit to Knurl on May 15.	$50,000
Fee earned by the bankruptcy trustee.	$12,000
Claim by Hill Co. for the delivery of televisions to Knurl on credit. The televisions were delivered on April 9, and a financing statement was properly filed on April 10. These televisions were sold by the trustee with Hill's consent for $7,000, their fair market value.	$ 7,000
Fees earned by the attorneys for the bankruptcy estate.	$ 8,000

The cash available for distribution includes the proceeds from the sale of the televisions. What amount will be distributed to Card if the cash available for distribution is $50,000?

a. $23,000
b. $30,000
c. $31,000
d. $43,000

N90#35. A bankrupt who filed voluntarily and received a discharge in bankruptcy under the provisions of Chapter 7 of the Federal Bankruptcy Code

a. May obtain another voluntary discharge in bankruptcy under Chapter 7 after five years have elapsed from the date of the prior filing.
b. Will receive a discharge of any and all debts owed.

c. Is precluded from owning or operating a similar business for two years.
d. Must surrender for distribution to the creditors any amount received as an inheritance if received within 180 days after filing the petition.

N89#22. Rolf, an individual, filed a voluntary petition in bankruptcy. A general discharge in bankruptcy will be denied if Rolf

a. Negligently made preferential transfers to certain creditors within 90 days of filing the petition.
b. Unjustifiably failed to preserve Rolf's books and records.
c. Filed a fraudulent federal income tax return two years prior to filing the petition.
d. Obtained a loan by using financial statements that Rolf knew were false.

N89#23. The filing of an involuntary petition in bankruptcy

a. Allows creditors to continue their collection actions against the debtor while the bankruptcy action is pending.
b. Terminates liens associated with exempt property.
c. Stops the enforcement of a judgment lien against property in the bankruptcy estate.
d. Terminates all security interests in property in the bankruptcy estate.

N89#25. Filing a valid petition in bankruptcy acts as an automatic stay of actions to

	Garnish the debtor's wages	*Collect alimony from the debtor*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N89#26. Eagle Corp. is a general creditor of Dodd. Dodd filed a petition in bankruptcy under the liquidation provisions of the Bankruptcy Code. Eagle wishes to have the bankruptcy court either deny Dodd a general discharge or not have its debt discharged. The discharge will be granted and it will include Eagle's debt even if

a. Dodd filed for and received a previous discharge in bankruptcy under the liquidation provisions within five years of the filing of the present petition.
b. Eagle's debt is unscheduled.
c. Eagle was a secured creditor **not** fully satisfied from the proceeds obtained on disposition of the collateral.
d. Dodd unjustifiably failed to preserve the records from which Dodd's financial condition might be ascertained.

N89#27. Which of the following assets would be included in a debtor's bankruptcy estate in a liquidation proceeding?

a. Proceeds from a life insurance policy received 90 days after the petition was filed.
b. An inheritance received 270 days after the petition was filed.
c. Property from a divorce settlement received 365 days after the petition was filed.
d. Wages earned by the debtor after the petition was filed.

N89#28. Which of the following unsecured debts of $500 each would have the highest relative priority in the distribution of a bankruptcy estate in a liquidation proceeding?

a. Tax claims of state and municipal governmental units.
b. Liabilities to employee benefit plans arising from services rendered during the month preceding the filing of the petition.
c. Claims owed to customers who gave deposits for the purchase of undelivered consumer goods.
d. Wages earned by employees during the month preceding the filing of the petition.

N89#29. As an alternative to bankruptcy liquidation, a business may reorganize under Chapter 11 of the Bankruptcy Code. Such a reorganization

a. Requires the appointment of a trustee to administer the debtor organization.
b. May be commenced by filing either a voluntary or involuntary petition.
c. Never requires the appointment of a creditors' committee.
d. May **not** be confirmed unless all creditors accept the plan.

N88
Items 23 and 24 are based on the following:

On July 15, 1988, White, a sole proprietor, was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. White's nonexempt property has been converted to $13,000 cash, which is available to satisfy the following claims:

Unsecured claim for 1986 state income tax	$10,000
Fee owed to Best & Co., CPAs, for services rendered from April 1, 1988, through June 30, 1988	$6,000
Unsecured claim by Stieb for wages earned as an employee of White during March, 1988	$3,000

There are no other claims.

23. What is the maximum amount that will be distributed for the payment of the 1986 state income tax?
    a. $ 4,000
    b. $ 5,000
    c. $ 7,000
    d. $10,000

24. What is the maximum amount that will be distributed to Stieb?
    a. $0
    b. $1,000
    c. $2,000
    d. $3,000

N88

Items 25 through 27 are based on the following:

On May 5, 1988, Bold obtained a $90,000 judgment in a malpractice action against Aker, a physician. On June 2, 1988, Aker obtained a $75,000 loan from Tint Finance Co. by knowingly making certain false representations to Tint. On July 7, 1988, Aker filed a voluntary petition in bankruptcy under the liquidation provisions of the Bankruptcy Code. Both Bold and Tint filed claims in Aker's bankruptcy proceeding. Assets in Aker's bankruptcy estate are exempt.

25. Bold's claim
    a. Will be excepted from Aker's discharge in bankruptcy.
    b. Will cause Aker to be denied a discharge in bankruptcy.
    c. Will be set aside as a preference.
    d. Will be discharged in Aker's bankruptcy proceeding.

26. Tint's claim
    a. Will be excepted from Aker's discharge in bankruptcy.
    b. Will cause Aker to be denied a discharge in bankruptcy.
    c. Will be set aside as a preference.
    d. Will be discharged in Aker's bankruptcy proceeding.

27. *For this item only,* assume that on June 9, 1988, Aker transferred property he owned to his son. The property was collateral for Aker's obligation to Simon. Aker transferred the property with the intent to defraud Simon. Which of the following statements is correct?
    a. Only Simon's debt will be excepted from Aker's discharge in bankruptcy.
    b. Aker will be denied a discharge in bankruptcy.
    c. The transfer will be set aside because it constitutes a preference.
    d. Aker will receive a discharge in bankruptcy of all debts.

N88#28. The Bankruptcy Code provides that a debtor is entitled to claim as exempt property the right to receive

	Social security benefits	*Disability benefits*
a.	No	No
b.	Yes	No
c.	Yes	Yes
d.	No	Yes

N88#29. Which of the following statements is correct under the reorganization provisions of the Bankruptcy Code?
    a. The court is required to appoint a trustee or an examiner in all cases.
    b. The creditors must appoint a trustee or an examiner after the bankruptcy petition is filed.
    c. The bankruptcy petition may only be filed voluntarily by the debtor.
    d. The court is required to appoint a committee of unsecured creditors.

M88

Items 28 through 31 are based on the following information:

Knox operates an electronics store as a sole proprietor. On April 5, 1988, Knox was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. On April 20, a trustee in bankruptcy was appointed and an order for relief was entered. Knox's non-exempt property has been converted to cash, which is available to satisfy the following claims and expenses as may be appropriate:

<u>*Claims and expenses*</u>

Claim by Dart Corp. (one of Knox's suppliers) for computers ordered on April 6, 1988 and delivered on credit to Knox on April 10, 1988.	$20,000
Fee earned by the bankruptcy trustee.	$15,000
Claim by Boyd for a deposit given to Knox on April 1, 1988, for a computer Boyd purchased for personal use but that had not yet been received by Boyd.	$1,500
Claim by Noll Co. for the delivery of stereos to Knox on credit. The stereos were delivered on March 4, 1988, and a financing statement was properly filed on March 5, 1988. These stereos were sold by the trustee with Noll's consent for $7,500, their fair market value.	$5,000
Fees earned by the attorneys for the bankruptcy estate.	$10,000
Claims by unsecured general creditors.	$1,000

The cash available for distribution includes the proceeds from the sale of the stereos.

28. What amount will be distributed to the trustee as a fee if the cash available for distribution is $15,000?
   a. $ 6,000
   b. $ 9,000
   c. $10,000
   d. $15,000

29. What amount will be distributed to Boyd if the cash available for distribution is $50,800?
   a. $ 480
   b. $ 800
   c. $ 900
   d. $1,500

30. What amount will be distributed to Dart if the cash available for distribution is $41,000?
   a. $10,100
   b. $11,000
   c. $16,000
   d. $20,000

31. If the trustee in bankruptcy wishes to avoid Noll's March 4 transaction with Knox as a preferential transfer, the trustee will
   a. Lose, because the transfer was in fact a substantially contemporaneous exchange for new value given.
   b. Lose, because there is **no** evidence that Knox was insolvent on March 4.
   c. Prevail, because the transfer occurred within 90 days of the filing of the bankruptcy petition.
   d. Prevail, because the financing statement was **not** filed on the day of delivery.

M88#32. Which of the following statements is correct with respect to a voluntary bankruptcy proceeding under the liquidation provisions of the Bankruptcy Code?
   a. The debtor must be insolvent.
   b. The liabilities of the debtor must total $5,000 or more.
   c. It may be properly commenced and maintained by any person who is insolvent.
   d. The filing of the bankruptcy petition constitutes an order for relief.

M88#33. In general, which of the following debts will be discharged under the voluntary liquidation provisions of the Bankruptcy Code?
   a. Debts incurred after the order for relief but before the debtor receives a discharge in bankruptcy.
   b. Income taxes due as the result of filing a fraudulent return seven years prior to the filing of the bankruptcy petition.
   c. A debt arising before the filing of the bankruptcy petition due to the debtor's negligence.
   d. Alimony payments owed to the debtor's spouse under a separation agreement entered into prior to the filing of the bankruptcy question.

M88#35. Which of the following statements is correct with respect to the reorganization provisions of the Bankruptcy Code?
   a. The commencement of a proceeding may be voluntary or involuntary.
   b. A partnership is **not** eligible to be a debtor.
   c. In all cases a trustee must be appointed.
   d. The debtor must be insolvent if the bankruptcy petition was filed voluntarily.

V. Government Regulation of Business

A. Regulation of Employment

M92#36. An employer who fails to withhold Federal Insurance Contributions Act (FICA) taxes from covered employees' wages, but who pays both the employer and employee shares would
   a. Be entitled to a refund from the IRS for the employees' share.
   b. Be allowed **no** federal tax deduction for any payments.
   c. Have a right to be reimbursed by the employees for the employees' share.
   d. Owe penalties and interest for failure to collect the tax.

M92#37. Unemployment tax payable under the Federal Unemployment Tax Act (FUTA), is
   a. Payable by all employers.
   b. Deducted from employee wages.
   c. Paid to the Social Security Administration.
   d. A tax deductible employer's expense.

M92#38. Workers' Compensation Acts require an employer to
   a. Provide coverage for all eligible employees.
   b. Withhold employee contributions from the wages of eligible employees.
   c. Pay an employee the difference between disability payments and full salary.
   d. Contribute to a federal insurance fund.

N91#32. Which of the following types of income is subject to taxation under the provisions of the Federal Insurance Contributions Act (FICA)?
   a. Interest earned on municipal bonds.
   b. Capital gains of $3,000.
   c. Car received as a productivity award.
   d. Dividends of $2,500.

N91#33. An unemployed CPA generally would receive unemployment compensation benefits if the CPA
a. Was fired as a result of the employer's business reversals.
b. Refused to accept a job as an accountant while receiving extended benefits.
c. Was fired for embezzling from a client.
d. Left work voluntarily without good cause.

N91#34. Workers' Compensation laws provide for all of the following benefits **except**
a. Burial expenses.
b. Full pay during disability.
c. The cost of prosthetic devices.
d. Monthly payments to surviving dependent children.

M91#36. Social security benefits may include all of the following **except**
a. Payments to divorced spouses.
b. Payments to disabled children.
c. Medicare payments.
d. Medicaid payments.

M91#37. An employer having an experience unemployment tax rate of 3.2% in a state having a standard unemployment tax rate of 5.4% may take a credit against a 6.2% federal unemployment tax rate of
a. 3.0%
b. 3.2%
c. 5.4%
d. 6.2%

M91#38. The primary purpose for enacting Workers' Compensation statutes was to
a. Eliminate all employer-employee negligence lawsuits.
b. Enable employees to recover for injuries regardless of negligence.
c. Prevent employee negligence suits against third parties.
d. Allow employees to recover additional compensation for employer negligence.

N90#36. Under the Federal Insurance Contributions Act (FICA), all of the following are considered wages **except**
a. Contingent fees.
b. Reimbursed travel expenses.
c. Bonuses.
d. Commissions.

N90#37. The Federal Unemployment Tax Act (FUTA)
a. Requires both the employer and employee to pay FUTA taxes, although the amounts to be paid by each are different.
b. Does **not** apply to businesses with fewer than 35 employees.
c. Does **not** apply to employers that conduct business only in one state and employ only residents of that state.
d. Allows the employer to take a credit against the FUTA tax if contributions are made to a state unemployment fund.

N90#38. If an employee is injured, full workers' compensation benefits are **not** payable if the employee
a. Was injured because of failing to abide by written safety procedures.
b. Was injured because of the acts of fellow employees.
c. Intentionally caused self-inflicted injury.
d. Brought a civil suit against a third party who caused the injury.

M90#26. Tower drives a truck for Musgrove Produce, Inc. The truck is owned by Musgrove. Tower is paid on the basis of a formula that takes into consideration the length of the trip, cargo, and fuel consumed. Tower is responsible for repairing or replacing all flat tires. Musgrove is responsible for all other truck maintenance. Tower drives only for Musgrove. If Tower is a common law employee and **not** an independent contractor, which of the following statements is correct?
a. All social security retirement benefits are fully includible in the determination of Tower's federal taxable income if certain gross income limitations are exceeded.
b. Musgrove remains primarily liable for Tower's share of FICA taxes if it fails to withhold and pay the taxes on Tower's wages.
c. Musgrove would **not** have to withhold FICA taxes if Tower elected to make FICA contributions as a self-employed person.
d. Bonuses or vacation pay that are paid to Tower by Musgrove are **not** subject to FICA taxes because they are **not** regarded as regular compensation.

M90#27. Taxes payable under the Federal Unemployment Tax Act (FUTA) are
a. Partially deductible by the covered employee for federal income tax purposes.
b. Calculated as a fixed percentage of all compensation paid to an employee.
c. Payable by all employers regardless of the total amount of compensation paid to individual employees.
d. Deductible by the employer as a business expense for federal income tax purposes.

N89#30. Which of the following statements is correct regarding social security taxes?
a. An individual who received net earnings from self-employment of $40,000 and wages of $40,000 in 1989 will be subject to social security taxes on $80,000.

b. Part of an employee's social security tax contribution qualifies for federal income tax purposes as a deduction from the employee's gross income.
c. A self-employed person is subject to social security taxes based on that person's gross earnings from self-employment.
d. An employer who fails to withhold and pay the employee's portion of social security taxes remains primarily liable for the employee's share.

N89#31. Which of the following statements is **not** correct concerning federal unemployment insurance?
a. Federal law provides general guidelines, standards, and requirements for the program.
b. The states administer the benefit payments under the program.
c. The program is funded by taxes imposed on employers and employees.
d. The federal unemployment tax is calculated as a fixed percentage of each covered employee's salary up to a stated maximum.

N89#32. An employee will generally be precluded from collecting full workers' compensation benefits when the injury is caused by

	Noncompliance with the employer's rules	*An intentional, self-inflicted action*
a.	No	No
b.	Yes	Yes
c.	No	Yes
d.	Yes	No

M89#36. The Federal Unemployment Tax Act
a. Imposes a tax on all employers doing business in the U.S.
b. Requires contributions to be made by the employer and employee equally.
c. Allows an employer to take a credit against the federal unemployment tax if contributions are made to a state unemployment fund.
d. Permits an employee to receive unemployment benefits that are limited to the contributions made to that employee's account.

M89#37. Under the Federal Insurance Contributions Act (FICA) and the Social Security Act (SSA),
a. Persons who are self-employed are **not** required to make FICA contributions.
b. Employees who participate in private retirement plans are **not** required to make FICA contributions.
c. Death benefits are payable to an employee's survivors only if the employee dies before reaching the age of retirement.
d. The receipt of earned income by a person who is also receiving social security retirement benefits may result in a reduction of such benefits.

M89#38. Which one of the following statements concerning workers' compensation laws is generally correct?
a. Workers' compensation laws are very narrowly construed against employees.
b. The amount of damages recoverable is based on comparative negligence.
c. Employers are strictly liable without regard to whether or not they are at fault.
d. Workers' compensation benefits are **not** available if the employee is grossly negligent.

N88#30. Which of the following statements is correct with respect to social security taxes and benefits?
a. A self-employed individual with net earnings of $35,000 will pay more tax than an employee with wages of $35,000.
b. Both employees and self-employed individuals are subject to social security taxes based on their respective gross wages or gross earnings from self-employment.
c. To the extent the amount received as retirement benefits is less than the amount contributed to the social security fund by the individual, it will **never** be included in the individual's adjusted gross income for federal income tax purposes.
d. An individual whose gross income exceeds certain maximum limitations is required to include the entire amount received as disability benefits in the computation of the individual's adjusted gross income for federal income tax purposes.

M88#43. Which of the following statements is correct with respect to social security taxes and benefits?
a. An individual whose gross income exceeds certain maximum limitations is required to include the entire amount received as disability benefits in the computation of taxable income.
b. Benefits are available to a qualifying individual or that individual's family only upon retirement or disability.
c. An employer that erroneously underwithholds and underpays an employee's share of social security taxes will be liable for the unpaid balance of the employee's share.
d. An individual whose private pension benefits exceed certain maximum limitations will have social security retirement benefits reduced.

M88#44. Bing was employed as a taxi driver by Speedy, Inc. While acting in the scope and course of his employment with Speedy, Bing collided with a van driven by Hart. Hart was an independent contractor making a delivery for Troy Corp. The collision was caused solely by Bing's negligence. As a result of the collision, both Bing and Hart suffered permanent injuries. Speedy and Troy were both in compliance with the state's workers' compensation statute. If Hart commences an action against Bing and Speedy for negligence, which of the following statements is correct?

a. Hart is entitled to recover damages from Bing or Speedy.
b. Bing will either be denied workers' compensation benefits or have his benefits reduced because of his negligence.
c. Hart's action for negligence will be dismissed because Hart is an independent contractor.
d. Hart is entitled to recover damages from Speedy's workers' compensation carrier to the extent **no** duplicate payment has been received by Hart.

M88#45. In general, which of the following statements is correct with respect to unemployment compensation?

a. An employee who is unable to work because of a disability is entitled to unemployment compensation.
b. An individual who has been discharged from employment because of work-connected misconduct is ineligible for unemployment compensation.
c. The maximum period during which unemployment compensation may be collected is uniform throughout the United States.
d. The maximum amount of weekly unemployment compensation payments made by a state is determined by federal law.

B. Federal Securities Acts

M92
Items 39 and 40 are based on the following:

World Corp. wanted to make a public offering of its common stock. On May 10, World prepared and filed a registration statement with the SEC. On May 20, World placed a "tombstone ad" announcing that it was making a public offering. On May 25, World issued a preliminary prospectus and the registration statement became effective on May 30.

39. On what date may World first make oral offers to sell the shares?

a. May 10.
b. May 20.
c. May 25.
d. May 30.

40. On what date may World first sell the shares?

a. May 10.
b. May 20.
c. May 25.
d. May 30.

M92
Items 41 and 42 are based on the following:

Integral Corp. has assets in excess of $4 million, has 350 stockholders, and has issued common and preferred stock. Integral is subject to the reporting provisions of the Securities Exchange Act of 1934. For its 1991 fiscal year, Integral filed the following with the SEC: quarterly reports, an annual report, and a periodic report listing newly appointed officers of the corporation. Integral did not notify the SEC of stockholder "short swing" profits; did not report that a competitor made a tender offer to Integral's stockholders; and did not report changes in the price of its stock as sold on the New York Stock Exchange.

41. Under SEC reporting requirements, which of the following was Integral required to do?

a. Report the tender offer to the SEC.
b. Notify the SEC of stockholder "short swing" profits.
c. File the periodic report listing newly appointed officers.
d. Report the changes in the market price of its stock.

42. Under the Securities Exchange Act of 1934, Integral must be registered with the SEC because

a. It issues both common and preferred stock.
b. Its shares are listed on a national stock exchange.
c. It has more than 300 stockholders.
d. Its shares are traded in interstate commerce.

M92#43. Under the Securities Act of 1933, which of the following securities must be registered?

a. Bonds of a railroad corporation.
b. Common stock of an insurance corporation.
c. Preferred stock of a domestic bank corporation.
d. Long-term notes of a charitable corporation.

M92#44. Data, Inc. intends to make a $375,000 common stock offering under Rule 504 of Regulation D of the Securities Act of 1933. Data

a. May sell the stock to an unlimited number of investors.
b. May make the offering through a general advertising.
c. Must offer the stock for a period of more than 12 months.
d. Must provide all investors with a prospectus.

M92#45. For an offering to be exempt under Regulation D of the Securities Act of 1933, Rules 504, 505, and 506 each require that

a. There be a maximum of 35 unaccredited investors.
b. All purchasers receive the issuer's financial information.
c. The SEC be notified within 10 days of the first sale.
d. The offering be made without general advertising.

N91#27. Wool, Inc. is a reporting company under the Securities Exchange Act of 1934. The only security it has issued is its voting common stock. Which of the following statements is correct?

a. It is unnecessary for the required annual report (Form 10K) to include audited financial statements.
b. Any person who owns more than 5% of Wool's common stock must file a report with the SEC.
c. Because Wool is a reporting company, it is **not** required to file a registration statement under the Securities Act of 1933 for any future offerings of its common stock.
d. Wool need **not** file its proxy statements with the SEC because it has only one class of stock outstanding.

N91#35. Exemption from registration under the Securities Act of 1933 would be available for

a. Promissory notes maturing in 12 months.
b. Securities of a bank.
c. Limited partnership interests.
d. Corporate bonds.

N91#36. When a common stock offering requires registration under the Securities Act of 1933,

a. The registration statement is automatically effective when filed with the SEC.
b. The issuer would act unlawfully if it were to sell the common stock without providing the investor with a prospectus.
c. The SEC will determine the investment value of the common stock before approving the offering.
d. The issuer may make sales 10 days after filing the registration statement.

N91#37. Under the Securities Act of 1933, an initial offering of securities must be registered with the SEC, unless

a. The offering is made through a broker-dealer licensed in the states in which the securities are to be sold.
b. The offering prospectus makes a fair and full disclosure of all risks associated with purchasing the securities.
c. The issuer's financial condition meets certain standards established by the SEC.
d. The type of security or the offering involved is exempt from registration.

N91#39. The reporting and registration provisions of the Securities Exchange Act of 1934

a. Do **not** require registration by a corporation if its stock was originally issued under an offering exempt from registration under the Securities Act of 1933.
b. Do **not** require registration by a corporation unless its stock is listed on a national securities exchange.
c. Require a corporation reporting under the Act to register any offering of its securities under the Securities Act of 1933.
d. Require a corporation reporting under the Act to file its proxy statements with the SEC even if it has only one class of stock outstanding.

N91#40. Kamp is offering $10 million of its securities. Under Rule 506 of Regulation D of the Securities Act of 1933,

a. The securities may be debentures.
b. Kamp must be a corporation.
c. There must be more than 35 purchasers.
d. Kamp may make a general solicitation in connection with the offering.

N91#41. Taso Limited Partnership intends to offer $400,000 of its limited partnership interests under Rule 504 of Regulation D of the Securities Act of 1933. Which of the following statements is correct?

a. The exemption under Rule 504 is **not** available to an issuer of limited partnership interests.
b. The limited partnership interests may be sold only to accredited investors.
c. The total number of nonaccredited investors who purchase the limited partnership interests may **not** exceed 35.
d. The resale of the limited partnership interests by a purchaser generally will be restricted.

M91#39. Bird Corp. made a $500,000 exempt common stock offering under Rule 504 of Regulation D of the Securities Act of 1933. This made the shares restricted securities. As the issuer of restricted securities, Bird must

a. Make a reasonable effort to determine that purchasers are buying for themselves and **not** for others.
b. Publicly advertise that the shares are **not** registered.
c. Provide information to all purchasers as to how they can register their shares so that resale will be permitted.
d. Apply to the SEC for contingent exemptions so that purchasers may resell their shares as exempt.

M91#40. Universal Corp. intends to sell its common stock to the public in an interstate offering that will be registered under the Securities Act of 1933. Under the Act,

a. Universal can make offers to sell its stock before filing a registration statement, provided that it does **not** actually issue stock certificates until after the registration is effective.
b. Universal's registration statement becomes effective at the time it is filed, assuming the SEC does **not** object within 20 days thereafter.

c. A prospectus must be delivered to each purchaser of Universal's common stock unless the purchaser qualifies as an accredited investor.
d. Universal's filing of a registration statement with the SEC does **not** automatically result in compliance with the "blue-sky" laws of the states in which the offering will be made.

M91#41. The registration of a security under the Securities Act of 1933 provides an investor with
a. A guarantee by the SEC that the facts contained in the registration statement are accurate.
b. An assurance against loss resulting from purchasing the security.
c. Information on the principal purposes for which the offering's proceeds will be used.
d. Information on the issuing corporation's trade secrets.

M91#42. Which of the following statements is correct regarding the proxy solicitation requirements of Section 14(a) of the Securities Exchange Act of 1934?
a. A corporation does **not** have to file proxy revocation solicitations with the SEC if it is a reporting company under the Securities Exchange Act of 1934.
b. Current unaudited financial statements must be sent to each stockholder with every proxy solicitation.
c. A corporation must file its proxy statements with the SEC if it is a reporting company under the Securities Exchange Act of 1934.
d. In a proxy solicitation by management relating to election of officers, all stockholder proposals must be included in the proxy statement.

M91#44. The antifraud provisions of Rule 10b-5 of the Securities Exchange Act of 1934
a. Apply only if the securities involved were registered under either the Securities Act of 1933 or the Securities Exchange Act of 1934.
b. Require that the plaintiff show negligence on the part of the defendant in misstating facts.
c. Require that the wrongful act must be accomplished through the mail, any other use of interstate commerce, or through a national securities exchange.
d. Apply only if the defendant acted with intent to defraud.

M91#45. Which of the following securities is exempt from the registration requirements of the Securities Act of 1933?
a. Common stock with **no** par value.
b. Warrants to purchase preferred stock.
c. Bonds issued by a charitable foundation.
d. Convertible debentures issued by a corporation.

M91#46. Winslow, Inc. intends to make a $450,000 common stock offering under Rule 504 of Regulation D of the Securities Act of 1933. Winslow
a. May make the offering through a general advertising.
b. Must provide all investors with a prospectus.
c. May sell the stock to an unlimited number of investors.
d. Must offer the stock for a period of 24 months.

N90#39. The registration requirements of the Securities Act of 1933 are intended to provide information to the SEC to enable it to
a. Evaluate the financial merits of the securities being offered.
b. Ensure that investors are provided with adequate information on which to base investment decisions.
c. Prevent public offerings of securities when management fraud or unethical conduct is suspected.
d. Assure investors of the accuracy of the facts presented in the financial statements.

N90#40. The registration provisions of the Securities Exchange Act of 1934 require disclosure of all of the following information **except** the
a. Names of owners of at least five (5) percent of any class of nonexempt equity security.
b. Bonus and profit-sharing arrangements.
c. Financial structure and nature of the business.
d. Names of officers and directors.

N90#41. Corporations that are exempt from registration under the Securities Exchange Act of 1934 are subject to the Act's
a. Provisions dealing with the filing of annual reports.
b. Provisions imposing periodic audits.
c. Antifraud provisions.
d. Proxy solicitation provisions.

N90#42. The Securities Act of 1933 provides an exemption from registration for

	Bonds issued by a municipality for governmental purposes	*Securities issued by a not-for-profit charitable organization*
a.	No	No
b.	Yes	No
c.	No	Yes
d.	Yes	Yes

N90#43. Imperial Corp. is offering $450,000 of its securities under Rule 504 of Regulation D of the Securities Act of 1933. Under Rule 504, Imperial is required to

a. Provide full financial information to all nonaccredited purchasers.
b. Make the offering through general solicitation.
c. Register the offering under the provisions of the Securities Exchange Act of 1934.
d. Notify the SEC within 15 days after the first sale of the securities.

N90#44. Hamilton Corp. is making a $4,500,000 securities offering under Rule 505 of Regulation D of the Securities Act of 1933. Under this regulation, Hamilton is

a. Required to provide full financial information to accredited investors only.
b. Allowed to make the offering through a general solicitation.
c. Limited to selling to **no** more than 35 nonaccredited investors.
d. Allowed to sell to an unlimited number of investors both accredited and nonaccredited.

N90#45. A $10,000,000 offering of corporate stock intended to be made pursuant to the provisions of Rule 506 of Regulation D of the Securities Act of 1933 would **not** be exempt under Rule 506 if

a. The offering was made through a general solicitation or advertising.
b. Some of the investors are nonaccredited.
c. There are more than 35 accredited investors.
d. The SEC was notified 14 days after the first sale of the securities.

M90#28. Which of the following is **least** likely to be considered a security under the Securities Act of 1933?

a. General partnership interests.
b. Limited partnership interests.
c. Stock options.
d. Warrants.

M90#29. Under the Securities Act of 1933, the registration of an interstate securities offering is

a. Required only in transactions involving more than $500,000.
b. Mandatory, unless the cost to the issuer is prohibitive.
c. Required, unless there is an applicable exemption.
d. Intended to prevent the marketing of securities which pose serious financial risks.

M90#30. Dice, Inc. is a reporting company under the Securities Exchange Act of 1934. The only security Dice issued is voting common stock. With regard to Dice's proxy solicitation requirements, which of the following statements is correct?

a. Dice must file its proxy statements with the SEC even though it has only one class of stock outstanding.
b. Dice's current unaudited financial statements must be sent to each shareholder with every proxy solicitation.
c. Shareholder proposals need **not** be included in the proxy statements unless consented to by a majority of Dice's board of directors.
d. Dice need **not** provide any particular information to its shareholders unless Dice is soliciting proxies from them.

M90#31. Under the Securities Exchange Act of 1934, which of the following individuals would **not** be subject to the insider reporting provisions?

a. An owner of ten percent of a corporation's stock.
b. An owner of five percent of a corporation's voting stock.
c. The vice-president of marketing.
d. A member of the board of directors.

M90#32. Which of the following are exempt from the registration requirements of the Securities Act of 1933?

a. Bankers' acceptances with maturities at the time of issue ranging from one to two years.
b. Participation interests in money market funds that consist wholly of short-term commercial paper.
c. Corporate stock offered and sold only to residents of the state in which the issuer was incorporated and is doing all of its business.
d. All industrial development bonds issued by municipalities.

M90#33. Pate Corp. is offering $3 million of its securities solely to accredited investors. Under Regulation D of the Securities Act of 1933, Pate is

a. Not required to provide any specified information to the accredited investors.
b. Permitted to make a general solicitation.
c. Not allowed to sell to investors using purchaser representatives.
d. Required to provide accredited investors with audited financial statements for the three most recent fiscal years.

M90#34. Regulation D of the Securities Act of 1933

a. Is limited to offers and sales of common stock that do **not** exceed $1.5 million.
b. Is exclusively available to small business corporations as defined by Regulation D.
c. Permits an exempt offering to be sold to both accredited and nonaccredited investors.
d. Restricts the number of purchasers of an offering to 35.

M90#37. Zack Limited Partnership intends to sell $6,000,000 of its limited partnership interests. Zack conducts all of its business activities in the state in which it was organized. Zack intends to use the offering proceeds to acquire municipal bonds. Which of the following statements is correct concerning the offering and the registration exemptions that might be available to Zack under the Securities Act of 1933?

a. The offering is exempt from registration because of the intended use of the offering proceeds.
b. Under Rule 147 (regarding intrastate offerings), Zack may make up to five offers to nonresidents without jeopardizing the Rule 147 exemption.
c. If Zack complies with the requirements of Regulation D, any subsequent resale of a limited partnership interest by a purchaser is automatically exempt from registration.
d. If Zack complies with the requirements of Regulation D, Zack may make an unlimited number of offers to sell the limited partnership interests.

N89#33. One of the elements necessary to recover damages if there has been a material misstatement in a registration statement filed pursuant to the Securities Act of 1933 is that the

a. Plaintiff suffered a loss.
b. Plaintiff gave value for the security.
c. Issuer and plaintiff were in privity of contract with each other.
d. Issuer failed to exercise due care in connection with the sale of the securities.

N89#34. To be successful in a civil action under Section 11 of the Securities Act of 1933 concerning liability for a misleading registration statement, the plaintiff must prove

	Defendant's intent to deceive	*Plaintiff's reliance on the registration statement*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N89#35. An issuer making an offering under the provisions of Regulation A of the Securities Act of 1933 must file a(an)

a. Prospectus.
b. Offering statement.
c. Shelf registration.
d. Proxy.

N89#36. Under the provisions of the Securities Exchange Act of 1934, a corporation whose common stock is listed on a national stock exchange

a. Is prohibited from making private placement offerings.
b. Must submit Form 10-K to the SEC except in those years in which the corporation has made a public offering.
c. Must distribute copies of Form 10-K to its shareholders.
d. Is subject to having the registration of its securities suspended or revoked.

N89#37. Rule 504 of Regulation D of the Securities Act of 1933 provides issuers with an exemption from registration for certain small issues. Which of the following statements is correct?

a. The rule allows sales to an unlimited number of investors.
b. The rule requires certain financial information to be furnished to the investors.
c. The issuer must offer the securities through general public advertising.
d. The issuer is **not** required to file anything with the SEC.

N89#38. Securities available under a private placement made pursuant to Regulation D of the Securities Act of 1933

a. Cannot be subject to the payment of commissions.
b. Must be sold to accredited institutional investors.
c. Must be sold to fewer than 20 non-accredited investors.
d. Cannot be the subject of an immediate unregistered reoffering to the public.

N89#39. Which of the following types of securities are generally exempt from registration under the Securities Act of 1933?

	Securities of nonprofit charitable organizations	*Securities of savings and loan associations*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M89#40. Acme Corp. intends to make a public offering in several states of 250,000 shares of its common stock. Under the Securities Act of 1933,

a. Acme must sell the common stock through licensed securities dealers.
b. Acme must, in all events, file a registration statement with the SEC because the offering will be made in several states.
c. Acme's use of any prospectus delivered to an unsophisticated investor must be accompanied by a simplified explanation of the offering.
d. Acme may make an oral offer to sell the common stock to a prospective investor after a registration statement has been filed but before it becomes effective.

M89#41. Pace Corp. previously issued 300,000 shares of its common stock. The shares are now actively traded on a national securities exchange. The original offering was exempt from registration under the Securities Act of 1933. Pace has $2,500,000 in assets and 425 shareholders. With regard to the Securities Exchange Act of 1934, Pace is

a. Required to file a registration statement because its assets exceed $2,000,000 in value.
b. Required to file a registration statement even though it has fewer than 500 shareholders.
c. Not required to file a registration statement because the original offering of its stock was exempt from registration.
d. Not required to file a registration statement unless insiders own at least 5% of its outstanding shares of stock.

M89#42. Rice, Inc. is a reporting company under the Securities Exchange Act of 1934. The only security it has issued is its voting common stock. Which one of the following statements is correct?

a. Any person who owns more than 5% of Rice's common stock must file a report with the SEC.
b. Rice need **not** file its proxy statements with the SEC because it has only one class of stock outstanding.
c. It is unnecessary for the required annual report (Form 10-K) to include audited financial statements.
d. Because Rice is a reporting company, it is **not** required to file a registration statement under the Securities Act of 1933 for any future offerings of its common stock.

M89#43. Which of the following securities is exempt from registration under the Securities Act of 1933?

a. A class of shares of stock given in exchange for another class by the issuer to its existing shareholders without payment of a commission.
b. Limited partnership interests sold for the purpose of acquiring funds to invest in bonds issued by the United States.
c. Corporate debentures that were previously subject to an effective registration statement, provided they are convertible into shares of common stock.
d. Shares of common stock, provided their par value is less than $1.00 and they are nonvoting.

M89
Items 44 and 45 are based on the following:

Maco Limited Partnership intends to sell $6,000,000 of its limited partnership interests. The state in which Maco was organized is also the state in which it carries on all of its business activities.

44. If Maco intends to offer the limited partnership interests in reliance on Rule 147, the intrastate registration exception under the Securities Act of 1933, which one of the following statements is correct?

a. Maco may make up to five offers to nonresidents without the offering being ineligible for the Rule 147 exemption.
b. The offering is **not** exempt under Rule 147 because it exceeds $5,000,000.
c. Under Rule 147, certain restrictions apply to resales of the limited partnership interests by purchasers.
d. Rule 147 limits to 100 the number of purchasers of the limited partnership interests.

45. If Maco intends to offer the limited partnership interests in reliance on Rule 506 of Regulation D under the Securities Act of 1933 to prospective investors residing in several states, which of the following statements is correct?

a. The offering will be exempt from the antifraud provisions of the Securities Exchange Act of 1934.
b. Any subsequent resale of a limited partnership interest by a purchaser will be exempt from registration.
c. Maco may make an unlimited number of offers to sell the limited partnership interests.
d. No more than 35 purchasers may acquire the limited partnership interests.

N88#31. Which of the following facts will result in an offering of securities being exempt from registration under the Securities Act of 1933?

a. The sale or offer to sell the securities is made by a person other than an issuer, underwriter, or dealer.
b. The securities are non-voting preferred stock.
c. The issuing corporation was closely held prior to the offering.
d. The securities are AAA-rated debentures that are collateralized by first mortgages on property that has a market value of 200% of the offering price.

N88#32. A plaintiff wishes to recover damages from the issuer for losses resulting from material misstatements in a securities registration statement. In order to be successful, one of the elements the plaintiff must prove is that the

a. Plaintiff was in privity of contract with the issuer or that the issuer knew of the plaintiff.
b. Plaintiff acquired the securities.
c. Issuer acted negligently.
d. Issuer acted fraudulently.

N88#33. Which of the following statements is correct concerning corporations subject to the reporting requirements of the Securities Exchange Act of 1934?

a. The annual report (form 10-K) need **not** include audited financial statements.
b. The annual report (form 10-K) must be filed with the SEC within 20 days of the end of the corporation's fiscal year.
c. A quarterly report (form 10-Q) need only be filed with the SEC by those corporations that are also subject to the registration requirements of the Securities Act of 1933.
d. A monthly report (form 8-K) must be filed with the SEC after the end of any month in which a materially important event occurs.

N88#34. Which of the following is a security that is exempt from the registration requirements of the Securities Act of 1933?

a. Convertible, subordinated debentures issued by a manufacturing company.
b. Warrants to purchase preferred stock.
c. Bonds issued by a charitable foundation.
d. Common stock with a par value of less than $1.00.

M88#36. The principal purpose of the registration requirements of the Securities Act of 1933 is to

a. Prevent public offerings of securities in which management fraud or unethical conduct is suspected.
b. Provide the SEC with the information necessary to determine the accuracy of the facts presented in the financial statements.
c. Assure that investors have adequate information upon which to base investment decisions.
d. Provide the SEC with the information necessary to evaluate the financial merits of the securities being offered.

M88#37. Unless an exemption applies to an offering of securities, the Securities Act of 1933 requires preparation and filing of a

	Registration statement	*Prospectus*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M88#38. Which of the following statements is correct with respect to the Securities Exchange Act of 1934?

a. Issuers whose securities are registered under the Act are required to comply with its reporting requirements.
b. The Act applies only to issuers whose securities are traded on a national securities exchange.
c. The Act subjects all issuers of securities to its registration requirements if the issuer has more than $2.5 million of assets or more than 250 shareholders.
d. The antifraud provisions of the Act do **not** apply to issuers of securities that are exempt from the Act's registration requirements.

M88#39. In order to raise $375,000, Penn Corp. is offering its securities under Rule 504 of Regulation D of the Securities Act of 1933. Under Rule 504, the offering

a. Must be sold to accredited investors.
b. Can **not** be sold to more than 35 non-accredited investors.
c. Can be sold to an unlimited number of accredited and non-accredited investors.
d. Will **not** subject the issuer to the antifraud provisions of the Securities Act of 1933.

M88#40. If securities are registered under the Securities Exchange Act of 1934, which of the following disclosure provisions apply?

	Notice of sales of the registered securities by the corporation's officers must be filed with the SEC	*Proxy material for the registered securities must be filed with the SEC*
a.	No	Yes
b.	Yes	No
c.	Yes	Yes
d.	No	No

M88#42. In general, the Securities Act of 1933 provides for an exemption from registration for

	A stock dividend issued to existing shareholders	*Bonds issued by a municipality for governmental purposes*
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

VI. Uniform Commercial Code

A. Commercial Paper

M92#46. The following endorsements appear on the back of a negotiable promissory note made payable "to bearer." Clark has possession of the note.

> Pay to Sam North
> *Alice Fox*
>
> *Sam North*
>
> (without recourse)

Which of the following statements is correct?

a. Clark's unqualified endorsement is required to further negotiate the note.
b. To negotiate the note, Clark must have given value for it.
c. Clark is **not** a holder because North's qualified endorsement makes the note nonnegotiable.
d. Clark can negotiate the note by delivery alone.

M92#47. To the extent that a holder of a negotiable promissory note is a holder in due course, the holder takes the note free of which of the following defenses?

a. Minority of the maker where it is a defense to enforcement of a contract.
b. Forgery of the maker's signature.
c. Discharge of the maker in bankruptcy.
d. Nonperformance of a condition precedent.

M92#48. Which of the following actions does **not** discharge a prior party to a commercial instrument?

a. Good faith payment or satisfaction of the instrument.
b. Cancellation of that prior party's endorsement.
c. The holder's oral renunciation of that prior party's liability.
d. The holder's intentional destruction of the instrument.

N91
Items 46 and 47 relate to the following instrument:

> May 19, 1991
>
> I promise to pay to the order of A.B. Shark $1,000 (One thousand and one hundred dollars) with interest thereon at the rate of 12% per annum.
>
> *T. T. Tile*
> T. T. Tile
>
> **Guaranty**
>
> I personally guaranty payment by T. T. Tile.
>
> *N. A. Abner*
> N. A. Abner

46. The instrument is a
    a. Promissory demand note.
    b. Sight draft.
    c. Check.
    d. Trade acceptance.

47. The instrument is
    a. Nonnegotiable even though it is payable on demand.
    b. Nonnegotiable because the numeric amount differs from the written amount.
    c. Negotiable even though a payment date is **not** specified.
    d. Negotiable because of Abner's guaranty.

N91#48. For a person to be a holder in due course of a promissory note

a. The note must be payable in U.S. currency to the holder.
b. The holder must be the payee of the note.
c. The note must be negotiable.
d. All prior holders must have been holders in due course.

N91#49. Cobb gave Garson a signed check with the amount payable left blank. Garson was to fill in, as the amount, the price of fuel oil Garson was to deliver to

Cobb at a later date. Garson estimated the amount at $700, but told Cobb it would be no more than $900. Garson did not deliver the fuel oil, but filled in the amount of $1,000 on the check. Garson then negotiated the check to Josephs in satisfaction of a $500 debt with the $500 balance paid to Garson in cash. Cobb stopped payment and Josephs is seeking to collect $1,000 from Cobb. Cobb's maximum liability to Josephs will be

a. $0
b. $ 500
c. $ 900
d. $1,000

N91#50. A subsequent holder of a negotiable instrument may cause the discharge of a prior holder of the instrument by any of the following actions **except**

a. Unexcused delay in presentment of a time draft.
b. Procuring certification of a check.
c. Giving notice of dishonor the day after dishonor.
d. Material alteration of a note.

N90#46. Union Co. possesses the following instrument:

Holt, MT $4,000 April 15, 1990

Fifty days after date, or sooner, the undersigned promises to pay to the order of

Union Co.

Four Thousand Dollars

at Salem Bank, Holt, MT

Ten percent interest per annum.

This instrument is secured by the maker's business inventory.

EASY, INC.

BY: *Thomas Foy*

Thomas Foy, President

Assuming all other requirements of negotiability are satisfied, this instrument is

a. Not negotiable because of a lack of a definite time for payment.
b. Not negotiable because the amount due is unspecified.
c. Negotiable because it is secured by the maker's inventory.
d. Negotiable because it is payable in a sum certain in money.

N90#47. A $5,000 promissory note payable to the order of Neptune is discounted to Bane by blank endorsement for $4,000. King steals the note from Bane and sells it to Ott who promises to pay King $4,500. After paying King $3,000, Ott learns that King stole the note. Ott makes no further payment to King. Ott is

a. A holder in due course to the extent of $5,000.
b. An ordinary holder to the extent of $4,500.
c. A holder in due course to the extent of $3,000.
d. An ordinary holder to the extent of $0.

N90#48. A maker of a note will have a valid defense against a holder in due course as a result of any of the following conditions **except**

a. Lack of consideration.
b. Infancy.
c. Forgery.
d. Fraud in the execution.

N90#49. The following note was executed by Elizabeth Quinton on April 17, 1990 and delivered to Ian Wolf:

(Face)

April 17, 1990

On demand, the undersigned promises to pay to the order of Ian Wolf

Seven Thousand and 00/100------------DOLLARS

Elizabeth Quinton

Elizabeth Quinton

(Back)

Ian Wolf

Ian Wolf

Pay: George Vernon

Samuel Thorn

Samuel Thorn

Pay: Alan Yule

George Vernon

George Vernon

Alan Yule

Alan Yule

In sequence, beginning with Wolf's receipt of the note, this note is properly characterized as what type of commercial paper?

a. Bearer, bearer, order, order, order.
b. Order, bearer, order, order, bearer.
c. Order, order, bearer, order, bearer.
d. Bearer, order, order, order, bearer.

M90#35. Which of the following negotiable instruments is subject to the provisions of the UCC Commercial Paper Article?

a. Installment note payable on the first day of each month.
b. Warehouse receipt.
c. Bill of lading payable to order.
d. Corporate bearer bond with a maturity date of January 1, 1999.

M90#36. Below is a copy of a note Prestige Properties obtained from Tim Hart in connection with Hart's purchase of land located in Hunter, MT. The note was given for the balance due on the purchase and was secured by a first mortgage on the land.

> $200,000.00 Hunter, MT
> November 30, 1989
>
> For value received, six years after date, I promise to pay to the order of Prestige Properties TWO HUNDRED THOUSAND and 00/100 DOLLARS with interest at 11% compounded annually until fully paid. This instrument arises out of the sale of land located in MT and the law of MT is to be applied to any question which may arise. It is secured by a first mortgage on the land conveyed. It is further agreed that:
> 1. Maker will pay the costs of collection including attorney's fees upon default.
> 2. Maker may repay the amount outstanding on any anniversary date of this note.
>
> *Tim Hart*
> Tim Hart

This note is a

a. Nonnegotiable promissory note because it is secured by a first mortgage.
b. Negotiable promissory note.
c. Nonnegotiable promissory note because it permits prepayment and requires the maker's payment of the costs of collection and attorney's fees.
d. Negotiable investment security under the UCC.

M90#38. Bond fraudulently induced Teal to make a note payable to Wilk, to whom Bond was indebted. Bond delivered the note to Wilk. Wilk negotiated the instrument to Monk, who purchased it with knowledge of the fraud and after it was overdue. If Wilk qualifies as a holder in due course, which of the following statements is correct?

a. Monk has the standing of a holder in due course through Wilk.
b. Teal can successfully assert the defense of fraud in the inducement against Monk.
c. Monk personally qualifies as a holder in due course.
d. Teal can successfully assert the defense of fraud in the inducement against Wilk.

M90#39. A holder in due course will take free of which of the following defenses?

a. Infancy, to the extent that it is a defense to a simple contract.
b. Discharge of the maker in bankruptcy.
c. A wrongful filling-in of the amount payable that was omitted from the instrument.
d. Duress of a nature that renders the obligation of the party a nullity.

M90#41. Fred Anchor is the holder of the following check:

> Peter Mason
> Champaign, Illinois 4/30 19 90
>
> Pay to the order of *Mary Nix or bearer* $*93.00*
>
> *Ninety-Three*-----------------------------------Dollars
>
> Second Bank 0453-0978
>
> *Peter Mason*

The check is endorsed on the back as follows:

> *Mary Nix*
> Pay to John Jacobs
> *Mark Harris*
> *John Jacobs*
> (without recourse)

Jacobs gave the check to his son as a gift, who transferred it to Anchor for $78.00. Which of the following statements is correct?

a. The unqualified endorsement of Jacobs was necessary in order to negotiate the check to his son.
b. Nix's endorsement was required to negotiate the check to any subsequent holder.
c. Anchor does **not** qualify as a holder because less than full consideration was given for the check.
d. The check is bearer paper in Jacobs' son's hands.

N89#40. A trade acceptance is an instrument drawn by a

a. Seller obligating the seller or designee to make payment.
b. Buyer obligating the buyer or designee to make payment.

c. Seller ordering the buyer or designee to make payment.
d. Buyer ordering the seller or designee to make payment.

N89#41. For which of the following negotiable instruments is a bank **not** an acceptor?
a. Cashier's check.
b. Certified check.
c. Certificate of deposit.
d. Bank acceptance.

N89#42. Which of the following is required to make an instrument negotiable?
a. Stated date of issue.
b. An indorsement by the payee.
c. Stated location for payment.
d. Payment only in legal tender.

N89#43. Blare bought a house and provided the required funds in the form of a certified check from a bank. Which of the following statements correctly describes the legal liability of Blare and the bank?
a. The bank has accepted; therefore, Blare is without liability.
b. The bank has **not** accepted; therefore, Blare has primary liability.
c. The bank has accepted, but Blare has secondary liability.
d. The bank has **not** accepted, but Blare has secondary liability.

N89#44. Silver Corp. sold 20 tons of steel to River Corp. with payment to be by River's check. The price of steel was fluctuating daily. Silver requested that the amount of River's check be left blank and Silver would fill in the current market price. River complied with Silver's request. Within two days, Silver received River's check. Although the market price of 20 tons of steel at the time Silver received River's check was $80,000, Silver filled in the check for $100,000 and negotiated it to Hatch Corp. Hatch took the check in good faith, without notice of Silver's act or any other defense, and in payment of an antecedent debt. River will
a. Not be liable to Hatch, because the check was materially altered by Silver.
b. Not be liable to Hatch, because Hatch failed to give value when it acquired the check from Silver.
c. Be liable to Hatch for $100,000.
d. Be liable to Hatch, but only for $80,000.

M89#46. On April 2, 1989, Harris agreed to sell a computer to Cross for $390. At the time of delivery, Cross gave Harris $90 and a written instrument, signed by Cross, in which Cross promised to pay Harris the balance on April 20, 1989. The instrument also made a reference to the sale of the computer. Under the UCC Commercial Paper Article, the instrument is a
a. Promissory note.
b. Non-negotiable draft.
c. Trade acceptance.
d. Negotiable time draft.

M89#48. The following instrument is in the possession of Bill North:

> On May 30, 1989, I promise to pay Bill North, the bearer of this document, $1,800.
>
> Joseph Peppers
> Joseph Peppers
>
> Re: Auto Purchase Contract

This instrument is
a. Non-negotiable because it is undated.
b. Non-negotiable because it is **not** payable to order or bearer.
c. Negotiable even though it makes reference to the contract out of which it arose.
d. Negotiable because it is payable at a definite time.

M89#49. Which one of the following aspects of an otherwise negotiable promissory note will render it non-negotiable?
a. The maker is obligated to pay a sum certain to the payee but may instead deliver to the payee goods of equal value.
b. The maker has the right to prepay the note, subject to a prepayment penalty of 10% of the amount prepaid.
c. The maker is obligated to pay the payee's costs of collection upon default by the maker.
d. The maker intentionally using a rubber stamp to sign the note.

M89#52. Jim Bass is in possession of a negotiable promissory note made payable "to bearer." Bass acquired the note from Mary Frank for value. The maker of the note was Fred Jackson. The following indorsements appear on the back of the note:

> Sam Peters
> Pay to Jim Bass
>
> Mary Frank
> Jim Bass
> (without recourse)

Bass presented the note to Jackson, who refused to pay it because he was financially unable to do so. Which of the following statements is correct?
a. Peters is **not** secondarily liable on the note because his indorsement was unnecessary for negotiation.

b. Peters is **not** secondarily liable to Bass.
c. Frank will probably **not** be liable to Bass unless Bass gives notice to Frank of Jackson's refusal to pay within a reasonable time.
d. Bass would have had secondary liability to Peters and Frank if he had **not** qualified his indorsement.

M89#59. A trade acceptance usually
a. Is an order to deliver goods to a named person.
b. Provides that the drawer is also the payee.
c. Is **not** regarded as commercial paper under the UCC.
d. Must be made payable "to the order of" a named person.

N88#35. Gold is holding the following instrument:

To: Sussex National Bank
Suffolk, N.Y.

October 15, 1988

Pay to the order of Tom Gold $2,000.00

Two Thousand and xx/100 Dollars

on November 1, 1988

Lester Davis

Lester Davis

This instrument is a
a. Postdated check.
b. Draft.
c. Promissory note.
d. Trade acceptance.

N88#36. A bank issues a negotiable instrument that acknowledges receipt of $50,000. The instrument also provides that the bank will repay the $50,000 plus 8% interest per annum to the bearer 90 days from the date of the instrument. The instrument is a
a. Certificate of deposit.
b. Time draft.
c. Trade or banker's acceptance.
d. Cashier's check.

N88#37. Which of the following would cause a promissory note to be nonnegotiable?
a. An acceleration clause that allows the holder to move up the maturity date of the note in the event of default.
b. An extension clause that allows the maker to elect to extend the time for payment to a date specified in the note.
c. A clause that allows the maker to satisfy the note by the performance of services or the payment of money.
d. A due date is **not** specified in the note.

N88#38. A secured promissory note would be nonnegotiable if it provided that
a. Additional collateral must be tendered if there is a decline in market value of the original collateral.
b. Upon default, the maker waives a trial by jury.
c. The maker is entitled to a 5% discount if the note is prepaid.
d. It is subject to the terms of the mortgage given by the maker to the payee.

N88#39. In general, which of the following statements is correct concerning the priority among checks drawn on a particular account and presented to the drawee bank on a particular day?
a. The checks may be charged to the account in any order convenient to the bank.
b. The checks may be charged to the account in any order provided **no** charge creates an overdraft.
c. The checks must be charged to the account in the order in which the checks were dated.
d. The checks must be charged to the account in the order of lowest amount to highest amount to minimize the number of dishonored checks.

N88#40. A purchaser of a negotiable instrument would **least** likely be a holder in due course if, at the time of purchase, the instrument is
a. Purchased at a discount.
b. Collateral for a loan.
c. Payable to bearer on demand.
d. Overdue by three weeks.

N88#41. Able drew a check payable to the order of Baker. The amount was left blank because it depended on a future delivery of fuel oil to Able, and the exact price was not known at the time the check was issued. Baker estimated the amount at $400, but told Able that in no event would it be more than $600. Baker failed to deliver the fuel oil, but filled in the amount of the check for $800. Baker then negotiated the check to Cook in satisfaction of a $600 debt, with the $200 balance paid to Baker in cash. Able stopped payment and Cook is seeking to collect $800 from Able. Able's maximum liability to Cook will be
a. $0
b. $400
c. $600
d. $800

M88#46. Ard is holding the following instrument:

> I, Rosemary Larkin, hereby promise to pay to the bearer twenty thousand dollars ($20,000). This document is given by me as payment of the balance due on my purchase of a 1984 Winnebago mobile home from Ed Dill and is payable when I am able to obtain a bank loan.
>
> Rosemary Larkin
>
> Rosemary Larkin

This instrument is **not** negotiable because it

a. Refers to the contract out of which it arose.
b. Is payable to bearer rather than to a named payee.
c. Is **not** dated on the face of the instrument.
d. Is **not** payable at a definite time.

M88#47. Assuming each of the following is negotiable, which qualifies as a draft under the UCC Commercial Paper Article?

a. A warehouse receipt.
b. A demand promissory note.
c. A document of title.
d. A trade acceptance.

M88#48. The value requirement in determining whether a person is a holder in due course with respect to a check will **not** be satisfied by the taking of the check

a. As security for an obligation to the extent of the obligation.
b. As payment for an antecedent debt.
c. In exchange for another negotiable instrument.
d. In exchange for a promise to perform services in the future.

B. Documents of Title and Investment Securities

M92#49. Under the UCC, a warehouse receipt

a. Is negotiable if, by its terms, the goods are to be delivered to bearer or to the order of a named person.
b. Will **not** be negotiable if it contains a contractual limitation on the warehouser's liability.
c. May qualify as both a negotiable warehouse receipt and negotiable commerical paper if the instrument is payable either in cash or by the delivery of goods.
d. May be issued only by a bonded and licensed warehouser.

M92#50. Sims owns a certificate representing 500 shares of Flow Corp.'s preferred stock. The shares were originally issued in Sims' name. If Sims agrees to sell the stock to Lazur for $1.00 per share, which of the following statements would be correct?

a. The sales agreement must be in writing and signed by both Sims and Lazur.
b. Sims must get Flow's consent before transferring the certificate to Lazur.
c. Lazur does **not** become a bona fide purchaser of the shares until Flow has registered the transfer of the stock certificate.
d. By transferring the stock certificate to Lazur, Sims warrants that the certificate is genuine and has **not** been materially altered.

M91#47. Which of the following statements is correct concerning a common carrier that issues a bill of lading stating that the goods are to be delivered "to the order of Ajax"?

a. The carrier's lien on the goods covered by the bill of lading for storage or transportation expenses is ineffective against the bill of lading's purchaser.
b. The carrier may **not**, as a matter of public policy, limit its liability for the goods by the terms of the bill.
c. The carrier must deliver the goods only to Ajax or to a person who presents the bill of lading properly endorsed by Ajax.
d. The carrier would have liability only to Ajax because the bill of lading is nonnegotiable.

N90#50. Kent stole several negotiable warehouse receipts from Baxter Sales Co. The receipts were deliverable to Baxter's order. Kent endorsed Baxter's name and sold the warehouse receipts to United Wholesalers, a bona fide purchaser. In an action by United against Baxter,

a. United will prevail because the warehouse receipts were converted to bearer instruments by Kent's endorsement.
b. United will prevail because it took the negotiable warehouse receipts as a bona fide purchaser for value.
c. Baxter will prevail because the warehouseman must be notified before any valid negotiation of a warehouse receipt is effective.
d. Baxter will prevail because Kent cannot validly negotiate the warehouse receipts.

N88#42. Which of the following is **not** a warranty made by the seller of a negotiable warehouse receipt to the purchaser of the document?

a. The document transfer is fully effective with respect to the goods it represents.
b. The warehouseman will honor the document.
c. The seller has **no** knowledge of any facts that would impair the document's validity.
d. The document is genuine.

M88#49. The procedure necessary to negotiate a document of title depends principally on whether the document is

a. An order document or a bearer document.
b. Issued by a bailee or a consignee.
c. A receipt for goods stored or goods already shipped.
d. A bill of lading or a warehouse receipt.

C. Sales

M92
Items 51 through 53 are based on the following:

On May 2, Lace Corp., an appliance wholesaler, offered to sell appliances worth $3,000 to Parco, Inc., a household appliances retailer. The offer was signed by Lace's president, and provided that it would not be withdrawn before June 1. It also included the shipping terms: "FOB — Parco's warehouse." On May 29, Parco mailed an acceptance of Lace's offer. Lace received the acceptance June 2.

51. Which of the following statements is correct if Lace sent Parco a telegram revoking its offer, and Parco received the telegram on May 25?

a. A contract was formed on May 2.
b. Lace's revocation effectively terminated its offer on May 25.
c. Lace's revocation was ineffective because the offer could **not** be revoked before June 1.
d. No contract was formed because Lace received Parco's acceptance after June 1.

52. Risk of loss for the appliances will pass to Parco when they are

a. Identified to the contract.
b. Shipped by Lace.
c. Tendered at Parco's warehouse.
d. Accepted by Parco.

53. If Lace inadvertently ships the wrong appliances to Parco and Parco rejects them two days after receipt, title to the goods will

a. Pass to Parco when they are identified to the contract.
b. Pass to Parco when they are shipped.
c. Remain with Parco until the goods are returned to Lace.
d. Revert to Lace when they are rejected by Parco.

M92#54. On May 2, Mason orally contracted with Acme Appliances to buy for $480 a washer and dryer for household use. Mason and the Acme salesperson agreed that delivery would be made on July 2. On May 5, Mason telephoned Acme and requested that the delivery date be moved to June 2. The Acme salesperson agreed with this request. On June 2, Acme failed to deliver the washer and dryer to Mason because of an inventory shortage. Acme advised Mason that it would deliver the appliances on July 2 as originally agreed. Mason believes that Acme has breached its agreement with Mason. Acme contends that its agreement to deliver on June 2 was not binding. Acme's contention is

a. Correct, because Mason is **not** a merchant and was buying the applicances for household use.
b. Correct, because the agreement to change the delivery date was **not** in writing.
c. Incorrect, because the agreement to change the delivery date was binding.
d. Incorrect, because Acme's agreement to change the delivery date is a firm offer that **cannot** be withdrawn by Acme.

M92#55. Which of the following conditions must be met for an implied warranty of fitness for a particular purpose to arise in connection with a sale of goods?

I. The warranty must be in writing.
II. The seller must know that the buyer was relying on the seller in selecting the goods.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

M92#56. On February 15, Mazur Corp. contracted to sell 1,000 bushels of wheat to Good Bread, Inc. at $6.00 per bushel with delivery to be made on June 23. On June 1, Good advised Mazur that it would not accept or pay for the wheat. On June 2, Mazur sold the wheat to another customer at the market price of $5.00 per bushel. Mazur had advised Good that it intended to resell the wheat. Which of the following statements is correct?

a. Mazur can successfully sue Good for the difference between the resale price and the contract price.
b. Mazur can resell the wheat only after June 23.
c. Good can retract its anticipatory breach at any time before June 23.
d. Good can successfully sue Mazur for specific performance.

M92#57. Under the UCC Sales Article, an action for breach of the implied warranty of merchantability by a party who sustains personal injuries may be successful against the seller of the product only when

a. The seller is a merchant of the product involved.
b. An action based on negligence can also be successfully maintained.
c. The injured party is in privity of contract with the seller.
d. An action based on strict liability in tort can also be successfully maintained.

M92#58. Morgan is suing the manufacturer, wholesaler, and retailer for bodily injuries caused by a power saw Morgan purchased. Which of the following statements is correct under the theory of strict liability?

a. The manufacturer will avoid liability if it can show it followed the custom of the industry.
b. Morgan may recover even if he **cannot** show any negligence was involved.
c. Contributory negligence on Morgan's part will always be a bar to recovery.
d. Privity will be a bar to recovery insofar as the wholesaler is concerned if the wholesaler did **not** have a reasonable opportunity to inspect.

M92#59. Under the UCC Sales Article, a seller will be entitled to recover the full contract price from the buyer when the

a. Goods are destroyed after title passed to the buyer.
b. Goods are destroyed while risk of loss is with the buyer.
c. Buyer revokes its acceptance of the goods.
d. Buyer rejects some of the goods.

M92#60. Which of the following factors result(s) in an express warranty with respect to a sale of goods?

I. The seller's description of the goods as part of the basis of the bargain.
II. The seller selects goods knowing the buyer's intended use.

a. I only.
b. II only.
c. Both I and II.
d. Neither I nor II.

M91#43. Under the UCC Sales Article, which of the following statements is correct concerning a contract involving a merchant seller and a non-merchant buyer?

a. Only the seller is obligated to perform the contract in good faith.
b. The contract will be either a sale or return or sale on approval contract.
c. The contract may **not** involve the sale of personal property with a price of more than $500.
d. Whether the UCC Sales Article is applicable does **not** depend on the price of the goods involved.

M91#48. With respect to the sale of goods, the warranty of title

a. Applies only if the seller is a merchant.
b. Applies only if it is in writing and signed by the seller.
c. Provides that the seller deliver the goods free from any lien of which the buyer lacked knowledge when the contract was made.
d. Provides that the seller cannot disclaim the warranty if the sale is made to a bona fide purchaser for value.

M91#49. Under a contract governed by the UCC Sales Article, which of the following statements is correct?

a. Unless both the seller and the buyer are merchants, neither party is obligated to perform the contract in good faith.
b. The contract will **not** be enforceable if it fails to expressly specify a time and a place for delivery of the goods.
c. The seller may be excused from performance if the goods are accidentally destroyed before the risk of loss passes to the buyer.
d. If the price of the goods is less than $500, the goods need **not** be identified to the contract for title to pass to the buyer.

M91#50. Under the UCC Sales Article, the implied warranty of merchantability

a. May be disclaimed by a seller's oral statement that mentions merchantability.
b. Arises only in contracts involving a merchant seller and a merchant buyer.
c. Is breached if the goods are **not** fit for all purposes for which the buyer intends to use the goods.
d. Must be part of the basis of the bargain to be binding on the seller.

M91#51. Yost Corp., a computer manufacturer, contracted to sell 15 computers to Ivor Corp., a computer retailer. The contract specified that delivery was to be made by truck to Ivor's warehouse. Instead, Yost shipped the computers by rail. When Ivor claimed that Yost did not comply with the contract, Yost told Ivor that there had been a trucker's strike when the goods were shipped. Ivor refused to pay for the computers. Under these circumstances, Ivor

a. Is obligated to pay for the computers because Yost made a valid substituted performance.
b. Is obligated to pay for the computers because title to them passed to Ivor when Ivor received them.
c. May return the computers and avoid paying for them because of the way Yost delivered them.
d. May return the computers and avoid paying for them because the contract was void under the theory of commercial impracticability.

M91#52. Gray Fabricating Co. and Pine Corp. agreed orally that Pine would custom manufacture a processor for Gray at a price of $80,000. After Pine completed the work at a cost of $60,000, Gray notified Pine that the processor was no longer needed. Pine is holding the processor and has requested payment from Gray. Pine has been unable to resell the processor for any price. Pine incurred storage fees of $1,000. If Gray refuses to pay Pine and Pine sues Gray, the most Pine will be entitled to recover is

a. $60,000
b. $61,000
c. $80,000
d. $81,000

M91#53. To establish a cause of action based on strict liability in tort for personal injuries resulting from using a defective product, one of the elements the plaintiff must prove is that the seller (defendant)

a. Defectively designed the product.
b. Was engaged in the business of selling the product.
c. Was in privity of contract with the plaintiff.
d. Failed to exercise due care.

M91#54. West purchased a painting from Noll, who is not in the business of selling art. Noll tendered delivery of the painting after receiving payment in full from West. West informed Noll that West would be unable to take possession of the painting until later that day. Thieves stole the painting before West returned. The risk of loss

a. Remained with Noll, because West had **not** yet received the painting.
b. Remained with Noll, because the parties agreed on a later time of delivery.
c. Passed to West at the time the contract was formed and payment was made.
d. Passed to West on Noll's tender of delivery.

M91
Items 55 and 56 are based on the following:

Lazur Corp. agreed to purchase 100 radios from Wizard Suppliers, Inc. Wizard is a wholesaler of small home appliances and Lazur is an appliance retailer. The contract required Wizard to ship the radios to Lazur by common carrier, "F.O.B. Wizard Suppliers, Inc. Loading Dock."

55. Risk of loss for the radios during shipment to Lazur would be on

a. Lazur, because the risk of loss passes when the radios are delivered to the carrier.
b. Wizard, because the risk of loss passes only when Lazur receives the radios.
c. Wizard, because it is a shipment contract.
d. Lazur, because title to the radios passes to Lazur at the time of shipment.

56. Under the UCC Sales Article

a. Title to the radios passes to Lazur at the time they are delivered to the carrier, even if the goods are nonconforming.
b. Lazur must inspect the radios at the time of delivery or waive any defects and the right to sue for breach of contract.
c. Wizard must pay the freight expense associated with the shipment of the radios to Lazur.
d. Lazur would have the right to reject any shipment if Wizard fails to notify Lazur that the goods have been shipped.

M90#40. To satisfy the UCC Statute of Frauds regarding the sale of goods, which of the following must generally be in writing?

a. Designation of the parties as buyer and seller.
b. Delivery terms.
c. Quantity of the goods.
d. Warranties to be made.

M90#42. Under the UCC Sales Article, the warranty of title may be excluded by

a. Merchants or non-merchants provided the exclusion is in writing.
b. Non-merchant sellers only.
c. The seller's statement that it is selling only such right or title that it has.
d. Use of an "as is" disclaimer.

M90#43. An important factor in determining if an express warranty has been created is whether the

a. Statements made by the seller became part of the basis of the bargain.
b. Sale was made by a merchant in the regular course of business.
c. Statements made by the seller were in writing.
d. Seller intended to create a warranty.

M90#44. Cey Corp. entered into a contract to sell parts to Deck, Ltd. The contract provided that the goods would be shipped "F.O.B. Cey's warehouse." Cey shipped parts different from those specified in the contract. Deck rejected the parts. A few hours after Deck informed Cey that the parts were rejected, they were destroyed by fire in Deck's warehouse. Cey believed that the parts were conforming to the contract. Which of the following statements is correct?

a. Regardless of whether the parts were conforming, Deck will bear the loss because the contract was a shipment contract.
b. If the parts were nonconforming, Deck had the right to reject them, but the risk of loss remains with Deck until Cey takes possession of the parts.
c. If the parts were conforming, risk of loss does **not** pass to Deck until a reasonable period of time after they are delivered to Deck.
d. If the parts were nonconforming, Cey will bear the risk of loss, even though the contract was a shipment contract.

M90#45. Pulse Corp. maintained a warehouse where it stored its manufactured goods. Pulse received an order from Star. Shortly after Pulse identified the goods to be shipped to Star, but before moving them to the loading dock, a fire destroyed the warehouse and its contents. With respect to the goods, which of the following statements is correct?

a. Pulse has title but **no** insurable interest.
b. Star has title and an insurable interest.
c. Pulse has title and an insurable interest.
d. Star has title but **no** insurable interest.

M90#46. Jefferson Hardware ordered three hundred Ram hammers from Ajax Hardware. Ajax accepted the order in writing. On the final date allowed for delivery, Ajax discovered it did not have enough Ram hammers to fill the order. Instead, Ajax sent three hundred Strong hammers. Ajax stated on the invoice that the shipment was sent only as an accommodation. Which of the following statements is correct?

a. Ajax's note of accommodation cancels the contract between Jefferson and Ajax.
b. Jefferson's order can only be accepted by Ajax's shipment of the goods ordered.
c. Ajax's shipment of Strong hammers is a breach of contract.
d. Ajax's shipment of Strong hammers is a counteroffer and **no** contract exists between Jefferson and Ajax.

M90#47. On September 10, Bell Corp. entered into a contract to purchase 50 lamps from Glow Manufacturing. Bell prepaid 40% of the purchase price. Glow became insolvent on September 19 before segregating, in its inventory, the lamps to be delivered to Bell. Bell will **not** be able to recover the lamps because

a. Bell is regarded as a merchant.
b. The lamps were **not** identified to the contract.
c. Glow became insolvent fewer than 10 days after receipt of Bell's prepayment.
d. Bell did **not** pay the full price at the time of purchase.

N89#45. Which of the following factors is least important in determining whether a manufacturer is strictly liable in tort for a defective product?

a. The negligence of the manufacturer.
b. The contributory negligence of the plaintiff.
c. Modifications to the product by the wholesaler.
d. Whether the product caused injuries.

N89#46. Cookie Co. offered to sell Distrib Markets 20,000 pounds of cookies at $1.00 per pound, subject to certain specified terms for delivery. Distrib replied in writing as follows:

> "We accept your offer for 20,000 pounds of cookies at $1.00 per pound, weighing scale to have valid city certificate."

Under the UCC

a. A contract was formed between the parties.
b. A contract will be formed only if Cookie agrees to the weighing scale requirement.
c. No contract was formed because Distrib included the weighing scale requirement in its reply.
d. No contract was formed because Distrib's reply was a counteroffer.

N89#47. DaGama bought a used boat from Magellan Marina, which disclaimed "any and all warranties" in connection with the sale. Magellan was unaware that the boat had been stolen from Colon. DaGama surrendered it to Colon when confronted with proof of the theft. DaGama sued Magellan. Who is likely to prevail and why?

a. Magellan, because of the general disclaimer.
b. Magellan, because it was unaware of the theft.
c. DaGama, because the warranty of title has been breached.
d. DaGama, because Magellan is a merchant.

N89#48. Which of the following factors is most important in deciding who bears the risk of loss between merchants when goods are destroyed during shipment?

a. The agreement of the parties.
b. Whether the goods are perishable.
c. Who has title at the time of the loss.
d. The terms of applicable insurance policies.

N89#49. On Monday, Wolfe paid Aston Co., a furniture retailer, $500 for a table. On Thursday, Aston notified Wolfe that the table was ready to be picked up. On Saturday, while Aston was still in possession of the table, it was destroyed in a fire. Who bears the loss of the table?

a. Wolfe, because Wolfe had title to the table at the time of loss.
b. Aston, unless Wolfe is a merchant.
c. Wolfe, unless Aston breached the contract.
d. Aston, because Wolfe had **not** yet taken possession of the table.

N89#51. Mayker, Inc. and Oylco contracted to have Oylco be the exclusive provider of Mayker's fuel oil for three months. The stated price was subject to increases of up to a total of 10% if the market price increased. The market price rose 25% and Mayker tripled its normal order. Oylco seeks to avoid performance. Olyco's best argument in support of its position is that

a. There was **no** meeting of the minds.
b. The contract was unconscionable.
c. The quantity was **not** definite and certain enough.
d. Mayker ordered amounts of oil unreasonably greater than its normal requirements.

N89#52. Under the UCC Sales Article, if a buyer wrongfully rejects goods, the aggrieved seller may

	Resell the goods and sue for damages	*Cancel the agreement*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M89#54. With regard to a contract governed by the UCC Sales Article, which one of the following statements is correct?

a. Merchants and non-merchants are treated alike.
b. The contract may involve the sale of any type of personal property.
c. The obligations of the parties to the contract must be performed in good faith.
d. The contract must involve the sale of goods for a price of more than $500.

M89
Items 55 through 58 are based on the following:

Lazur Corp. entered into a contract with Baker Suppliers, Inc. to purchase a used word processor from Baker. Lazur is engaged in the business of selling new and used word processors to the general public. The contract required Baker to ship the goods to Lazur by common carrier pursuant to the following provision in the contract: "F.O.B. — Baker Suppliers, Inc. loading dock." Baker also represented in the contract that the word processor had been used for only 10 hours by its previous owner. The contract included the provision that the word processor was being sold "as is" and this provision was in a larger and different type style than the remainder of the contract.

55. With regard to the contract between Lazur and Baker,

a. An implied warranty of merchantability does **not** arise unless both Lazur and Baker are merchants.
b. The "as is" provision effectively disclaims the implied warranty of title.
c. No express warranties are created by the contract.
d. The "as is" provision would **not** prevent Baker from being liable for a breach of any express warranties created by the contract.

56. *For this item only,* assume that during shipment to Lazur the word processor was seriously damaged when the carrier's truck was involved in an accident. When the carrier attempted to deliver the word processor, Lazur rejected it and has refused to pay Baker the purchase price. Under the UCC Sales Article,

a. Lazur rightfully rejected the damaged computer.
b. The risk of loss for the computer was on Lazur during shipment.
c. At the time of the accident, risk of loss for the computer was on Baker because title to the computer had **not** yet passed to Lazur.
d. Lazur will **not** be liable to Baker for the purchase price of the computer because of the F.O.B. provision in the contract.

57. *For this item only,* assume that the contract between Lazur and Baker is otherwise silent. Under the UCC Sales Article,

a. Lazur must pay Baker the purchase price before Baker is required to ship the word processor to Lazur.
b. Baker does **not** warrant that it owns the word processor.
c. Lazur will be entitled to inspect the word processor before it accepts or pays for it.
d. Title to the word processor passes to Lazur when it takes physical possession.

58. *For this item only,* assume that Lazur refused to accept the word processor even though it was in all respects conforming to the contract and that the contract is otherwise silent. Under the UCC Sales Article,

a. Baker can successfully sue for specific performance and make Lazur accept and pay for the word processor.
b. Baker may resell the word processor to another buyer.
c. Baker must sue for the difference between the market value of the word processor and the contract price plus its incidental damages.
d. Baker cannot successfully sue for consequential damages unless it attempts to resell the word processor.

N88#43. In general, the UCC Sales Article applies to the sale of

a. Goods only if the seller is a merchant and the buyer is **not**.
b. Goods only if the seller and buyer are both merchants.
c. Consumer goods by a non-merchant.
d. Real estate by a merchant for $500 or more.

N88#44. Under the UCC Sales Article, a firm offer will be created only if the

a. Offeree is a merchant.
b. Offeree gives some form of consideration.
c. Offer states the time period during which it will remain open.
d. Offer is made by a merchant in a signed writing.

N88#45. Which of the following factors will be most important in determining whether an express warranty has been created concerning goods sold?

a. The seller gave a description of the goods that is part of the basis of the bargain.
b. The buyer or seller is a merchant with respect to the goods being sold.
c. Whether the seller intended to create the express warranty.
d. Whether the buyer relied on the seller's statements.

N88#46. If goods have been delivered to a buyer pursuant to a sale or return contract, the

a. Buyer may use the goods but **not** resell them.
b. Seller is liable for the expenses incurred by the buyer in returning the goods to the seller.
c. Title to the goods remains with the seller.
d. Risk of loss for the goods passed to the buyer.

N88#47. Which of the following is necessary in order for the warranty of merchantability to arise where there has been a sale of goods?

I. The seller must be a merchant with respect to goods of that kind.
II. The warranty must be in writing.
III. The buyer must have relied on the seller's skill or judgment in selecting the goods.

a. I and III only.
b. I, II, and III.
c. II and III only.
d. I only.

N88#48. Cain and Zen Corp. orally agreed that Zen would specially manufacture a machine for Cain at a price of $40,000. After Zen completed the work at a cost of $30,000, Cain notified Zen that it no longer needed the machine. Zen is holding the machine for Cain and has requested payment from Cain. Despite making reasonable efforts, Zen has been unable to resell the machine for any price. Zen has incurred warehouse fees of $500 for storing the machine. If Cain refuses to pay Zen and Zen sues Cain, the most Zen will be entitled to recover is

a. $0
b. $30,500
c. $40,000
d. $40,500

N88#49. Sutter purchased a computer from Harp. Harp is not in the business of selling computers. Harp tendered delivery of the computer after receiving payment in full from Sutter. Sutter informed Harp that Sutter was unable to take possession of the computer at that time, but would return later that day. Before Sutter returned, the computer was destroyed by a fire. The risk of loss

a. Remained with Harp, since title had **not** yet passed to Sutter.
b. Passed to Sutter upon Harp's tender of delivery.
c. Remained with Harp, since Sutter had **not** yet received the computer.
d. Passed to Sutter at the time the contract was formed and payment was made.

N88#50. Bean ordered 40 beige refrigerators at list price from Tish Co. Immediately upon receipt of Bean's order, Tish sent Bean an acceptance which was received by Bean. The acceptance indicated that shipment would be made within ten days. On the tenth day Tish discovered that all of its supply of beige refrigerators had been sold. Instead it shipped 40 white refrigerators, stating clearly on the invoice that the shipment was sent only as an accommodation. Which of the following is correct?

a. Bean's order is a unilateral offer, and can only be accepted by Tish's shipment of the goods ordered.
b. Tish's shipment of white refrigerators is a counteroffer, thus **no** contract exists between Bean and Tish.
c. Tish's note of accommodation cancels the contract between Tish and Bean.
d. Tish's shipment of white refrigerators constitutes a breach of contract.

N88#51. On March 7, 1988, Wax Corp. contracted with Noll Wholesalers to supply Noll with specific electrical parts. Delivery was called for on June 3, 1988. On May 2, 1988, Wax notified Noll that it would not perform and that Noll should look elsewhere. Wax had received a larger and more lucrative contract on April 21, 1988, and its capacity was such that it could not fulfill both orders. The facts

a. Will prevent Wax from retracting its repudiation of the Noll contract.
b. Are **not** sufficient to clearly establish an anticipatory repudiation.
c. Will permit Noll to sue only after June 3, 1988, the latest performance date.
d. Will permit Noll to sue immediately after May 2, 1988, even though the performance called for under the contract was **not** due until June 3, 1988.

M88#50. Under the UCC Sales Article, which of the following warranties requires the seller to be a merchant with respect to the goods being sold in order for the warranty to apply?

	Implied warranty of fitness for a particular purpose	*Implied warranty of merchantability*
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

D. Secured Transactions

M91#57. Pix Co., which is engaged in the business of selling appliances, borrowed $18,000 from Lux Bank. Pix executed a promissory note for that amount and pledged all of its customer installment receivables as collateral for the loan. Pix executed a security agreement that described the collateral, but Lux did not file a financing statement. With respect to this transaction

a. Attachment of the security interest did **not** occur because Pix failed to file a financing statement.
b. Perfection of the security interest occurred despite Lux's failure to file a financing statement.

c. Attachment of the security interest took place when the loan was made and Pix executed the security agreement.
d. Perfection of the security interest did **not** occur because accounts receivable are intangibles.

M91#58. Carr Corp. sells VCRs and video tapes to the public. Carr sold and delivered a VCR to Sutter on credit. Sutter executed and delivered to Carr a promissory note for the purchase price and a security agreement covering the VCR. Sutter purchased the VCR for personal use. Carr did not file a financing statement. Is Carr's security interest perfected?

a. No, because the VCR was a consumer good.
b. No, because Carr failed to file a financing statement.
c. Yes, because Carr retained ownership of the VCR.
d. Yes, because it was perfected at the time of attachment.

M91#59. On June 15, Harper purchased equipment for $100,000 from Imperial Corp. for use in its manufacturing process. Harper paid for the equipment with funds borrowed from Eastern Bank. Harper gave Eastern a security agreement and financing statement covering Harper's existing and after-acquired equipment. On June 21, Harper was petitioned involuntarily into bankruptcy under Chapter 7 of the Federal Bankruptcy Code. A bankruptcy trustee was appointed. On June 23, Eastern filed the financing statement. Which of the parties will have a superior security interest in the equipment?

a. The trustee in bankruptcy, because the filing of the financing statement after the commencement of the bankruptcy case would be deemed a preferential transfer.
b. The trustee in bankruptcy, because the trustee became a lien creditor before Eastern perfected its security interest.
c. Eastern, because it had a perfected purchase money security interest without having to file a financing statement.
d. Eastern, because it perfected its security interest within the permissible time limits.

M91#60. Wine purchased a computer using the proceeds of a loan from MJC Finance Company. Wine gave MJC a security interest in the computer. Wine executed a security agreement and financing statement, which was filed by MJC. Wine used the computer to monitor Wine's personal investments. Later, Wine sold the computer to Jacobs, for Jacobs' family use. Jacobs was unaware of MJC's security interest. Wine now is in default under the MJC loan. May MJC repossess the computer from Jacobs?

a. No, because Jacobs was unaware of the MJC security interest.
b. No, because Jacobs intended to use the computer for family or household purposes.
c. Yes, because MJC's security interest was perfected before Jacobs' purchase.
d. Yes, because Jacobs' purchase of the computer made Jacobs personally liable to MJC.

M90#49. Sun, Inc. manufactures and sells household appliances on credit directly to wholesalers, retailers, and consumers. Sun can perfect its security interest in the appliances without having to file a financing statement or take possession of the appliances if the sale is made by Sun to

a. Consumers.
b. Wholesalers that sell to buyers in the ordinary course of business.
c. Retailers.
d. Wholesalers that sell to distributors for resale.

M90#51. Vista is a wholesale seller of microwave ovens. Vista sold 50 microwave ovens to Davis Appliance for $20,000. Davis paid $5,000 down and signed a promissory note for the balance. Davis also executed a security agreement giving Vista a security interest in Davis' inventory, including the ovens. Vista perfected its security interest by properly filing a financing statement in the state of Whiteacre. Six months later, Davis moved its business to the state of Blackacre, taking the ovens. On arriving in Blackacre, Davis secured a loan from Grange Bank and signed a security agreement putting up all inventory (including the ovens) as collateral. Grange perfected its security interest by properly filing a financing statement in the state of Blackacre. Two months after arriving in Blackacre, Davis went into default on both debts. Which of the following statements is correct?

a. Grange's security interest is superior because Grange had **no** actual notice of Vista's security interest.
b. Vista's security interest is superior even though at the time of Davis' default Vista had **not** perfected its security interest in the state of Blackacre.
c. Grange's security interest is superior because Vista's time to file a financing statement in Blackacre had expired prior to Grange's filing.
d. Vista's security interest is superior provided it repossesses the ovens before Grange does.

N89#50. Under the UCC Secured Transactions Article, for a security interest to attach, the

a. Debtor must agree to the creation of the security interest.
b. Creditor must properly file a financing statement.
c. Debtor must be denied all rights in the collateral.
d. Creditor must take and hold the collateral.

N89#53. Perfection of a security interest permits the secured party to protect its interest by

a. Avoiding the need to file a financing statement.
b. Preventing another creditor from obtaining a security interest in the same collateral.
c. Establishing priority over the claims of most subsequent secured creditors.
d. Denying the debtor the right to possess the collateral.

N89#54. Roth and Dixon both claim a security interest in the same collateral. Roth's security interest attached on January 1, 1989, and was perfected by filing on March 1, 1989. Dixon's security interest attached on February 1, 1989, and was perfected on April 1, 1989, by taking possession of the collateral. Which of the following statements is correct?

a. Roth's security interest has priority because Roth perfected before Dixon perfected.
b. Dixon's security interest has priority because Dixon's interest attached before Roth's interest was perfected.
c. Roth's security interest has priority because Roth's security interest attached before Dixon's security interest attached.
d. Dixon's security interest has priority because Dixon is in possession of the collateral.

N89#55. Under the UCC Secured Transactions Article, if a debtor is in default under a payment obligation secured by goods, the secured party has the right to

	Reduce the claim to a judgment	*Sell the goods and apply the proceeds toward the debt*	*Take possession of the goods without judicial process*
a.	Yes	Yes	No
b.	Yes	No	Yes
c.	No	Yes	Yes
d.	Yes	Yes	Yes

M89#47. Acorn Marina, Inc. sells and services boat motors. On April 1, 1989, Acorn financed the purchase of its entire inventory with GAC Finance Company. GAC required Acorn to execute a security agreement and financing statement covering the inventory and proceeds of sale. On April 14, 1989, GAC properly filed the financing statement pursuant to the UCC Secured Transactions Article. On April 27, 1989, Acorn sold one of the motors to Wilks for use in his charter business. Wilks, who had once worked for Acorn, knew that Acorn regularly financed its inventory with GAC. Acorn has defaulted on its obligations to GAC. The motor purchased by Wilks is

a. Subject to the GAC security interest because Wilks should have known that GAC financed the inventory purchase by Acorn.
b. Subject to the GAC security interest because Wilks purchased the motor for a commercial use.
c. Not subject to the GAC security interest because Wilks is regarded as a buyer in the ordinary course of Acorn's business.
d. Not subject to the GAC security interest because GAC failed to file the financing statement until more than 10 days after April 1, 1989.

M89#60. Burn Manufacturing borrowed $500,000 from Howard Finance Co., secured by Burn's present and future inventory, accounts receivable, and the proceeds thereof. The parties signed a financing statement that described the collateral and it was filed in the appropriate state office. Burn subsequently defaulted in the repayment of the loan and Howard attempted to enforce its security interest. Burn contended that Howard's security interest was unenforceable. In addition, Green, who subsequently gave credit to Burn without knowledge of Howard's security interest, is also attempting to defeat Howard's alleged security interest. The security interest in question is valid with respect to

a. Both Burn and Green.
b. Neither Burn nor Green.
c. Burn but **not** Green.
d. Green but **not** Burn.

N88#52. Mern Corp. is in the business of selling computers and computer software to the public. Mern sold and delivered a personal computer to Whyte on credit. Whyte executed and delivered to Mern a promissory note for the purchase price and a security agreement covering the computer. If Whyte purchased the computer for personal use and Mern fails to file a financing statement, which of the following statements is correct?

a. The computer was a consumer good while in Mern's possession.
b. Perfection of Mern's security interest occurred at the time of attachment.
c. Mern's security interest is **not** enforceable against Whyte because Mern failed to file a financing statement.
d. Mern does **not** have a perfected security interest because it failed to file a financing statement.

N88#53. Dart Co., which is engaged in the business of selling appliances, borrowed $8,000 from Arco Bank. Dart executed a promissory note for that amount and pledged all of its customer installment receivables as collateral for the loan. Dart executed a security agreement which described the collateral, but Arco did not file a financing statement. With respect to this transaction

a. Attachment of the security interest took place when Dart executed the security agreement.
b. Attachment of the security interest did **not** occur because Arco failed to file a financing statement.

c. Perfection of the security interest occurred despite Arco's failure to file a financing statement.
d. The UCC Secured Transactions Article does **not** apply because Arco failed to file a financing statement.

N88#54. With regard to a prior perfected security interest in goods for which a financing statement has been filed, which of the following parties is most likely to have a superior interest in the same collateral?
a. A buyer in the ordinary course of business who purchased the goods from a merchant.
b. A subsequent buyer of consumer goods who purchased the goods from another consumer.
c. The trustee in bankruptcy of the debtor.
d. Lien creditors of the debtor.

N88#55. Bonn, a secured party, sells collateral at a private sale to a good faith purchaser for value after the debtor defaults. Which of the following statements is correct under the UCC Secured Transactions Article?
a. In all cases, the collateral will remain subject to the security interests of subordinate lien creditors.
b. The security interest under which the sale was made and any security interest or lien subordinate to it will be discharged.
c. In all cases, Bonn may **not** buy the collateral at a private sale.
d. Bonn will be entitled to receive a first priority in the sale proceeds.

VII. Property

A. Real and Personal Property

N91#51. A tenant's personal property will become a fixture and belong to the landlord if its removal would
a. Increase the value of the personal property.
b. Cause a material change to the personal property.
c. Result in substantial harm to the landlord's property.
d. Change the use of the landlord's property back to its prior use.

N91#52. Konrad, Van, and Star own a parcel of land as joint tenants with right of survivorship. Konrad's interest was sold to Dawson. As a result of the sale from Konrad to Dawson,
a. Van and Star each own one-third of the land as tenants in common.
b. Van, Star, and Dawson each own one-third of the land as joint tenants.
c. Dawson owns one-third of the land as a joint tenant.
d. Dawson owns one-third of the land as a tenant in common.

N91#53. To be enforceable, a residential real estate lease must
a. Require the tenant to obtain liability insurance.
b. Entitle the tenant to exclusive possession of the leased property.
c. Specify a due date for rent.
d. Be in writing.

N91#54. A purchaser who obtains real estate title insurance will
a. Have coverage for the title exceptions listed in the policy.
b. Be insured against all defects of record other than those excepted in the policy.
c. Have coverage for title defects that result from events that happen after the effective date of the policy.
d. Be entitled to transfer the policy to subsequent owners.

N90#51. Jones and Newton each own a one-half interest in certain real property as tenants in common. Jones' interest
a. Will pass by operation of law to Newton on Jones' death.
b. Will pass on Jones' death to Jones' heirs.
c. May **not** be transferred during Jones' lifetime.
d. Is considered a life estate.

N90#52. Bronson is a residential tenant with a 10-year written lease. In the absence of specific provisions in the lease to the contrary, which of the following statements is correct?
a. The premises may **not** be sublet for less than the full remaining lease term.
b. Bronson may **not** assign the lease.
c. The landlord's death will automatically terminate the lease.
d. Bronson's purchase of the property will terminate the lease.

N90#53. Unless an exception to title is noted in the title insurance policy, a title insurance company will be liable to a land purchaser for

a. Closing costs.
b. Recorded easements.
c. Unrecorded assessments.
d. Zoning violations.

N90#56. Which of the following deeds will give a real property purchaser the greatest protection?

a. Quitclaim.
b. Bargain and sale.
c. Special warranty.
d. General warranty.

M90#50. A person may own property as a joint tenant with the right of survivorship with any of the following **except** a(an)

a. Divorced spouse.
b. Related minor child.
c. Unaffiliated corporation.
d. Unrelated adult.

M90#52. Ivor, Queen, and Lear own a building as joint tenants with the right of survivorship. Ivor donated his interest in the building to Day Charity by executing and delivering a deed to Day. Both Queen and Lear refused to consent to Ivor's transfer to Day. Subsequently, Queen and Lear died. After their deaths, Day's interest in the building consisted of

a. Total ownership due to the deaths of Queen and Lear.
b. No interest because Queen and Lear refused to consent to the transfer.
c. A 1/3 interest as a joint tenant.
d. A 1/3 interest as a tenant in common.

M90#53. A tenant renting an apartment under a three-year written lease that does **not** contain any specific restrictions may be evicted for

a. Counterfeiting money in the apartment.
b. Keeping a dog in the apartment.
c. Failing to maintain a liability insurance policy on the apartment.
d. Making structural repairs to the apartment.

M90#54. Delta Corp. leased 60,000 square feet in an office building from Tanner under a written 25-year lease. Which of the following statements is correct?

a. Tanner's death will terminate the lease and Delta will be able to recover any resulting damages from Tanner's estate.
b. Tanner's sale of the office building will terminate the lease unless both Delta and the buyer consented to the assumption of the lease by the buyer.
c. In the absence of a provision in the lease to the contrary, Delta does **not** need Tanner's consent to assign the lease to another party.
d. In the absence of a provision in the lease to the contrary, Delta would need Tanner's consent to enter into a sublease with another party.

M90#55. On February 2, Mazo deeded a warehouse to Parko for $450,000. Parko did not record the deed. On February 12, Mazo deeded the same warehouse to Nexis for $430,000. Nexis was aware of the prior conveyance to Parko. Nexis recorded its deed before Parko recorded. Who would prevail under the following recording statutes?

	Notice statute	*Race statute*	*Race-Notice statute*
a.	Nexis	Parko	Parko
b.	Parko	Nexis	Parko
c.	Parko	Nexis	Nexis
d.	Parko	Parko	Nexis

N89#56. A buyer of real estate who receives a title insurance policy will

a. Take title free of all defects.
b. Be able to transfer the policy to a subsequent buyer of the real estate.
c. Not have coverage for title exceptions listed in the insurance policy.
d. Not have coverage greater than the amount of any first mortgage.

N88#56. Green and Nunn own a 40-acre parcel of land as joint tenants with the right of survivorship. Nunn wishes to sell the land to Ink. If Nunn alone executes and delivers a deed to Ink, what will be the result?

a. Green will retain a 1/2 undivided interest in the 40-acre parcel, and will be unable to set aside Nunn's conveyance to Ink.
b. Ink will obtain an interest in 1/2 of the parcel, or 20 acres.
c. Ink will share ownership of the 40 acres with Green as a joint tenant with a right of survivorship.
d. The conveyance will be invalid because Green did **not** sign the deed.

N88#57. Tell, Inc. leased a building from Lott Corp. Tell paid monthly rent of $500 and was also responsible for paying the building's real estate taxes. On January 1, 1987, Vorn Co. and Tell entered into an agreement by which Vorn was entitled to occupy the building for the remainder of the term of Tell's lease in exchange for monthly payments of $600 to Tell. For the year 1987, neither Tell nor Vorn paid the building's real estate taxes and the taxes are delinquent. Learning this, Lott demanded that either Tell or Vorn pay the delinquent taxes. Both refused to do so and Lott has commenced an action against them. Lott will most likely prevail against

a. Vorn because the lease was assigned to it.
b. Tell and Vorn because both are jointly and severally liable for the delinquent taxes.
c. Tell without Vorn because their January 1 agreement constituted a sublease.
d. Vorn but only to the extent of $100 for each month that it occupied the building during 1987.

N88#58. Which of the following deeds gives the grantee the **least** amount of protection?

a. Bargain and sale deed.
b. Grant deed.
c. Quitclaim deed.
d. Warranty deed.

M88#51. A purchaser of real property who wishes to receive the broadest protection with respect to the property being conveyed should obtain a

a. Bargain and sale deed.
b. General warranty deed.
c. Quitclaim deed.
d. Grant deed.

M88
Items 53 and 54 are based on the following information:

Boch and Kent are equal owners of a warehouse. Boch died leaving a will that gave his wife all of his right, title, and interest in his real estate.

53. If Boch and Kent owned the warehouse at all times as joint tenants with the right of survivorship, Boch's interest

a. Will pass to his wife after the will is probated.
b. Will **not** be included in his gross estate for federal estate tax purposes.
c. Could **not** be transferred before Boch's death without Kent's consent.
d. Passed to Kent upon Boch's death.

54. If Boch and Kent owned the warehouse at all times as tenants in common, which of the following statements is correct?

a. Boch's interest will pass to his wife after the will is probated.
b. Upon Boch's death, all tenancies in common terminated.
c. Boch's interest will **not** be included in his gross estate for federal estate tax purposes.
d. Upon Boch's death, his interest passed to Kent.

M88#55. Sisk is a tenant of Met Co. and has two years remaining on a six-year lease executed by Sisk and Met. The lease prohibits subletting but is silent as to Sisk's right to assign the lease. Sisk assigned the lease to Kern Corp. which assumed all of Sisk's obligations under the lease. Met objects to the assignment. Which of the following statements is correct?

a. The assignment to Kern is voidable at Met's option.
b. Sisk would have been relieved from liability on the lease with Met if Sisk obtained Met's consent to the assignment.
c. Sisk will remain liable to Met for the rent provided for in the lease.
d. With respect to the rent provided for in the lease, Kern is liable to Sisk but **not** to Met.

B. Mortgages

N91#55. A mortgage on real property must

a. Be acknowledged by the mortgagee.
b. State the exact amount of the debt.
c. State the consideration given for the mortgage.
d. Be delivered to the mortgagee.

N91#56. If a mortgagee fails to record its mortgage in a jurisdiction with a notice-race recording statute,

a. A subsequent recording mortgagee who has **no** knowledge of the prior mortgage will have a superior security interest.
b. A subsequent recording mortgagee who has knowledge of the prior mortgage will have a superior security interest.
c. A subsequent purchaser for value who has **no** knowledge of the mortgage will take the property subject to the mortgage.
d. A subsequent purchaser for value who has knowledge of the mortgage will take the property free of the prior security interest.

N91#57. Which of the following is correct regarding foreclosure of a purchase money mortgage by judicial sale of the property?

a. The mortgagor has the right to any remaining sale proceeds after the mortgagee is paid.
b. The purchaser at the sale is liable for any deficiency owed the mortgagee.
c. The court must confirm any price received at the sale.
d. The mortgagor can never be liable for a deficiency owed the mortgagee.

N91#58. Wyn bought real estate from Duke and gave Duke a purchase money mortgage. Duke forgot to record the mortgage. Two months later, Wyn gave a mortgage on the same property to Goode to secure a property improvement loan. Goode recorded this mortgage nine days later. Goode knew about the Duke mortgage. If these events took place in a notice-race statute jurisdiction, which mortgage would have priority?

a. Duke's, because it was the first mortgage given.
b. Duke's, because Goode knew of the Duke mortgage.

c. Goode's, because it was the first mortgage recorded.
d. Goode's, because it was recorded within ten days.

N90#54. Sklar Corp. owns a factory that has a fair market value of $90,000. Dall Bank holds an $80,000 first mortgage and Rice Finance holds a $20,000 second mortgage on the factory. Sklar has discontinued payments to Dall and Rice, who have foreclosed on their mortgages. If the factory is properly sold to Bond at a judicial sale for $90,000, after expenses,

a. Rice will receive $10,000 out of the proceeds.
b. Dall will receive $77,500 out of the proceeds.
c. Bond will take the factory subject to the unsatisfied portion of any mortgage.
d. Rice has a right of redemption after the judicial sale.

N90#55. To be enforceable against the mortgagor, a mortgage must meet all the following requirements **except**

a. Be delivered to the mortgagee.
b. Be in writing and signed by the mortgagor.
c. Be recorded by the mortgagee.
d. Include a description of the debt and land involved.

N90#58. Ritz owned a building on which there was a duly recorded first mortgage held by Lyn and a recorded second mortgage held by Jay. Ritz sold the building to Nunn. Nunn assumed the Jay mortgage and had no actual knowledge of the Lyn mortgage. Nunn defaulted on the payments to Jay. If both Lyn and Jay foreclosed, and the proceeds of the sale were insufficient to pay both Lyn and Jay,

a. Jay would be paid after Lyn was fully paid.
b. Jay and Lyn would be paid proportionately.
c. Nunn would be personally liable to Lyn but **not** to Jay.
d. Nunn would be personally liable to Lyn and Jay.

N90#59. Gilmore borrowed $60,000 from Dix Bank. The loan was used to remodel a building owned by Gilmore as investment property and was secured by a second mortgage that Dix did not record. FCA Loan Company has a recorded first mortgage on the building. If Gilmore defaults on both mortgages, Dix

a. Will **not** be entitled to any mortgage foreclosure sale proceeds, even if such proceeds are in excess of the amount owed to FCA.
b. Will be unable to successfully claim any security interest in the building.
c. Will be entitled to share in any foreclosure sale proceeds *pro rata* with FCA.
d. Will be able to successfully claim a security interest that is subordinate to FCA's security interest.

M90#56. On April 6, Ford purchased a warehouse from Atwood for $150,000. Atwood had executed two mortgages on the property: a purchase money mortgage given to Lang on March 2, which was not recorded; and a mortgage given to Young on March 9, which was recorded the same day. Ford was unaware of the mortgage to Lang. Under the circumstances,

a. Ford will take title to the warehouse subject only to Lang's mortgage.
b. Ford will take title to the warehouse free of Lang's mortgage.
c. Lang's mortgage is superior to Young's mortgage because Lang's mortgage is a purchase money mortgage.
d. Lang's mortgage is superior to Young's mortgage because Lang's mortgage was given first in time.

M90#57. Sussex, Inc. had given a first mortgage when it purchased its plant and warehouse. Sussex needed additional working capital. It decided to obtain financing by giving a second mortgage on the plant and warehouse. Which of the following statements is true with respect to the mortgages?

a. Default on payment of the second mortgage will constitute default on the first mortgage.
b. The second mortgage may **not** be prepaid without the consent of the first mortgagee.
c. The second mortgagee may **not** pay off the first mortgage to protect its security.
d. If both mortgages are foreclosed, the first mortgage must be fully paid before paying the second mortgage.

M90#58. If a mortgagor defaults in the payment of a purchase money mortgage, and the mortgagee forecloses, the mortgagor may do any of the following **except**

a. Obtain any excess monies resulting from a judicial sale after payment of the mortgagee.
b. Remain in possession of the property after a foreclosure sale if the equity in the property exceeds the balance due on the mortgage.
c. Refinance the mortgage with another lender and repay the original mortgage.
d. Assert the equitable right of redemption by paying the mortgagee.

N89#57. If a borrower is in default under a purchase money mortgage loan, the

a. Lender can file suit to have the borrower declared insolvent.
b. Person who sold the real estate to the borrower can be forced to assume the mortgage debt.
c. Lender may file suit for foreclosure.
d. Lender may unilaterally obtain title without a foreclosure suit.

N89#58. Ram Corp. owns a warehouse that has a fair market value of $280,000. Area Bank holds a first mortgage and Public Finance holds a second mortgage on the warehouse. Ram has discontinued payments to Area and Public. As a result, Area, which has an outstanding mortgage of $240,000, and Public, which has an outstanding mortgage of $60,000, have foreclosed on their respective mortgages. If the warehouse is properly sold to Quincy at a judicial sale for $280,000, after expenses,

a. Public will receive $40,000 out of the proceeds.
b. Area will receive $224,000 out of the proceeds.
c. Public has a right of redemption after the judicial sale.
d. Quincy will take the warehouse subject to the unsatisfied portion of any mortgage.

N88#59. In general, a mortgage on real estate

a. Must be recorded to validate the mortgagee's (lender's) rights against the mortgagor (borrower).
b. Must be signed by the mortgagee and mortgagor to create an enforceable instrument.
c. Encumbers the mortgagor's legal title to the real estate.
d. Gives the mortgagee the right to possess the real estate.

N88#60. In 1982, Smith gave a mortgage to State Bank to secure a $100,000 loan. The mortgage was silent as to whether it would secure any other loans made by State to Smith. In 1984 Smith gave a second mortgage to Penn Bank to secure an $80,000 loan. Both mortgages described the same land and were properly recorded shortly after being executed by Smith. By 1988 Smith had repaid State Bank $40,000 of the $100,000 debt. State Bank then loaned Smith an additional $20,000 without taking any new security. Within a few days, Smith defaulted on the loans from both banks and the first and second mortgages were foreclosed. The balance on the Penn loan was $20,000. The net proceeds of the foreclosure sale were $70,000. State is entitled to receive from the proceeds a maximum of

a. $52,500.
b. $56,000.
c. $60,000.
d. $70,000.

M88#52. In general, which of the following statements is correct with respect to a real estate mortgage?

a. The mortgage must be in writing and signed by both the mortgagor (borrower) and mortgagee (lender).
b. The mortgagee may assign the mortgage to a third party without the mortgagor's consent.
c. The mortgage need **not** contain a description of the real estate covered by the mortgage.
d. The mortgage must contain the actual amount of the underlying debt and the rate of interest.

M88#56. Bell obtained a $30,000 loan from Arco Bank, executing a promissory note and mortgage. The loan was secured by a building that Bell purchased from Marx for $50,000. Arco's recording of the mortgage

a. Generally does **not** affect the rights of Bell and Arco against each other under the promissory note.
b. Generally creates a possessory security interest in Arco.
c. Cuts off the rights of all prior and subsequent lessees of the building.
d. Transfers legal title to the building to Arco.

M88#57. On April 6, 1988, Walsh purchased a warehouse from Bock for $150,000. Best Title Co. had performed a title search of the property. The results of the title search indicated that a mortgage given to Stone by Bock was duly recorded against the warehouse on March 9, 1988. However, the title search failed to detect a purchase money mortgage dated March 2, 1988, given by Bock to Todd. This mortgage was never recorded. Walsh was unaware of the mortgage to Todd. Under the circumstances,

a. Walsh will take title to the warehouse subject to Todd's mortgage because it is a purchase money mortgage.
b. Walsh will take title to the warehouse free of Todd's mortgage.
c. Todd's mortgage is superior to Stone's mortgage.
d. Best will be liable to Walsh because of its failure to detect the Todd mortgage.

C. Fire and Casualty Insurance

N91#59. In 1985, Ring purchased a building for $90,000 and insured it with a $90,000 fire insurance policy having a standard 80% coinsurance clause. Ring never increased the amount of the policy. In 1990, the building, worth $120,000, was destroyed by fire. What amount could Ring collect from the insurance company?

a. $0
b. $ 72,000
c. $ 90,000
d. $120,000

N91#60. Mason Co. maintained two standard fire insurance policies on one of its warehouses. Both policies included an 80% coinsurance clause and a typical "other insurance" clause. One policy was with Ace Fire Insurance, Inc., for $24,000, and the other was with Thrifty Casualty Insurance Co., for $16,000. At a time when the warehouse was worth $100,000, a fire in the warehouse caused a $40,000 loss. What amounts can Mason recover from Ace and Thrifty, respectively?

a. $0 and $0.
b. $10,000 and $10,000.
c. $12,000 and $8,000.
d. $24,000 and $16,000.

N90#57. One of the primary purposes of including a coinsurance clause in a property insurance policy is to

a. Encourage the policyholder to insure the property for an amount close to its full value.
b. Make the policyholder responsible for the entire loss caused by some covered perils.
c. Cause the policyholder to maintain a minimum amount of liability insurance that will increase with inflation.
d. Require the policyholder to insure the property with only one insurance company.

N90#60. On February 1, Papco Corp. entered into a contract to purchase an office building from Merit Company for $500,000 with closing scheduled for March 20. On February 2, Papco obtained a $400,000 standard fire insurance policy from Abex Insurance Company. On March 15, the office building sustained a $90,000 fire loss. On March 15, which of the following is correct?

I. Papco has an insurable interest in the building.
II. Merit has an insurable interest in the building.

a. I only.
b. II only
c. Both I and II.
d. Neither I nor II.

M90#59. Lawfo Corp. maintains a $200,000 standard fire insurance policy on one of its warehouses. The policy includes an 80% coinsurance clause. At the time the warehouse was originally insured, its value was $250,000. The warehouse now has a value of $300,000. If the warehouse sustains $30,000 of fire damage, Lawfo's insurance recovery will be a maximum of

a. $20,000
b. $24,000
c. $25,000
d. $30,000

M90#60. Orr is an employee of Vick Corp. Vick relies heavily on Orr's ability to market Vick's products and, for that reason, has acquired a $50,000 insurance policy on Orr's life. Half of the face value of the policy is payable to Vick and the other half is payable to Orr's spouse. Orr dies shortly after the policy is taken out but after leaving Vick's employ. Which of the following statements is correct?

a. Orr's spouse does **not** have an insurable interest because the policy is owned by Vick.
b. Orr's spouse will be entitled to all of the proceeds of the policy.
c. Vick will **not** be entitled to any of the proceeds of the policy because Vick is **not** a creditor or relative of Orr.
d. Vick will be entitled to its share of the proceeds of the policy regardless of whether Orr is employed by Vick at the time of death.

N89#59. McArthur purchased a house for $60,000. The house is insured for $64,000 and the insurance policy has an 80% coinsurance provision. Storms caused $12,000 worth of damage when the house had a fair market value of $120,000. What maximum amount will McArthur recover from the insurance company?

a. $ 8,000.
b. $ 9,000.
c. $ 9,600.
d. $12,000.

N89#60. To recover under a property insurance policy, an insurable interest must exist

	When the policy is purchased	*At the time of loss*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M88#59. On April 2, 1987, Ritz Corp. purchased a warehouse that it insured for $500,000. The policy contained a 75% coinsurance clause. On April 25, 1988, a fire caused $900,000 damage to the warehouse. The fair market value of the warehouse was $800,000 on April 2, 1987, and $1 million on April 25, 1988. Ritz is entitled to receive insurance proceeds of, at most,

a. $375,000.
b. $500,000.
c. $600,000.
d. $750,000.

M88#60. Beal occupies an office building as a tenant under a 25-year lease. Beal also has a mortgagee's (lender's) interest in an office building owned by Hill Corp. In which capacity does Beal have an insurable interest?

	Tenant	*Mortgagee*
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. The CPA and the Law

A. Common Law Liability to Clients and Third Persons

N91# 1 d
N91# 2 a
N91# 3 c
N91# 4 a
N91# 5 a
N90# 1 c
N90# 2 b
N90# 3 a
N90# 4 c
N90# 5 a
M89# 1 b
M89# 2 b
M89# 6 b
M89# 7 c
M88# 2 b

B. Federal Statutory Liability

M92# 2 c
M92# 3 c
M92# 4 a
M92# 5 c
N91# 6 b
N91# 7 b
N91# 8 c
N91# 9 b
N90# 6 a
N90# 7 b
N90# 8 c
M89# 3 d
M89# 4 a
M89# 8 c
M88# 8 c
M88# 9 b

C. Workpapers, Privileged Communication, and Confidentiality

M92# 1 d
N91# 10 d
N90# 9 b
N90# 10 d
M89# 5 d

II. Business Organizations

A. Agency

M92# 6 c
M92# 7 b
M92# 8 b
M92# 9 a
N91# 11 c
N91# 12 c
N91# 13 c
M91# 1 c
M91# 2 b
M91# 3 c
M90# 1 c
M90# 2 d
M90# 4 c
M90# 5 b
N89# 2 b
N89# 3 c
M89# 11 b
M89# 12 b
M89# 13 c
N88# 2 a
M88# 4 a
M88# 5 d
M88# 6 b

B. Partnerships and Joint Ventures

M92# 10 d
M92# 11 c
M92# 12 b
M92# 13 a
M92# 14 c
N91# 14 b
N91# 15 c
N91# 16 d
N91# 17 a
N90# 11 a
N90# 12 c
N90# 13 c
N90# 14 b
N89# 4 d
N89# 5 d
N89# 6 b
N89# 7 d
M89# 14 b
M89# 15 d
M89# 16 a
N88# 4 a
M88# 7 a
M88# 13 c
M88# 14 d

C. Corporations

M92# 15 c
M92# 16 d
M92# 17 c
M92# 18 c
M92# 19 a
M92# 20 d
M91# 4 d
M91# 5 c
M91# 6 a
M91# 7 b
N90# 15 d
N90# 16 b
N90# 17 b
N90# 18 b
M90# 6 b
M90# 7 d
M90# 8 c
M90# 9 b
N88# 5 b
N88# 7 c
M88# 15 c

D. Estates and Trusts

N91# 18 b
N91# 19 d
N91# 20 a
M91# 8 b
M91# 9 a
M91# 10 d
N90# 19 a
N90# 20 d
M90# 10 c
N89# 8 c
M89# 17 a
M89# 18 d
M89# 19 a
M89# 20 c
N88# 6 a
N88# 8 c
N88# 9 c
M88# 10 b
M88# 12 c

III. Contracts

A. Offer and Acceptance

M92#21 b
M92#22 b
M91#11 c
M91#12 a
M90#12 b
M90#13 c
M90#14 d
N89# 9 c
M89#21 c
M89#22 d
M89#23 d
M89#25 a
N88# 10 b
N88# 11 c
N88# 12 a
M88#16 c
M88#17 a

B. Consideration

M92#23 b
M92#24 d
M91#16 a
N90# 21 a
M90#11 a
M90#16 b
N89# 10 a
M89#24 a
M88#18 b

C. Capacity, Legality, and Public Policy

M92#25 d
M91#13 d
N90# 22 d
M90#17 b
N89# 11 b
M89#26 b
N88# 13 d
M88#19 a

D. Statute of Frauds

M92#26 d
M91#14 b
M91#17 b
M90#15 c
M90#20 a
N89# 12 c
M89#27 d
M89#29 c
N88# 14 c
M88#20 d

E. Statute of Limitations

M92#27 a
M91#15 d
N89# 13 a
M88#22 b

F. Fraud, Duress, and Undue Influence

M92#28 b
N91# 21 a
N91# 22 b
M91#20 d
N90# 23 c
M90#21 c
N89# 14 d
M89#28 c
M88#25 c

G. Mistake and Misrepresentation

M92#29 c
M91#21 c
M90#23 b
N89# 15 c
M89#30 c
N88# 16 d

H. Parol Evidence Rule

M92#30 a
N91# 23 c
M91#18 c
N89# 16 b
M88#21 d

I. Third Party Rights

M92#33 d
M91#19 d
M91#22 c
N90# 24 b
M90#19 a
M90#24 d
N89# 17 a
M89#32 a
N88# 17 b

J. Assignments

M92#31 a
M92#34 c
N91# 24 d
M91#28 a
M90#22 c
N89# 18 b
M89#33 d
N88# 18 d
M88#23 d

K. Discharge, Breach, and Remedies

M92#32 c
M92#35 d
N91# 25 c
M91#23 a
M91#24 b
N90# 25 b
M90#25 d
N89# 19 c
M89#34 d
M89#35 b
N88# 19 a
M88#24 a

IV. Debtor-Creditor Relationships

A. Suretyship

N91# 26 b
N91# 38 d
M91#25 d
M91#26 c
M91#27 b
N90# 26 d
N89# 20 b
N89# 21 a
N88# 21 c
M88#26 d

B. Bankruptcy

N91# 28 d
N91# 29 a
N91# 30 b
N91# 31 d
N91# 42 d
N91# 43 c
N91# 44 c
N91# 45 b
M91#29 d
M91#30 d
M91#31 a
M91#32 d
M91#33 c
M91#34 a
M91#35 a
N90# 27 b
N90# 28 c
N90# 29 d
N90# 30 d
N90# 31 d
N90# 32 d
N90# 33 c
N90# 34 a
N90# 35 d
N89# 22 b
N89# 23 c
N89# 25 b
N89# 26 c
N89# 27 a
N89# 28 d
N89# 29 b
N88# 23 d
N88# 24 b
N88# 25 d
N88# 26 a
N88# 27 b
N88# 28 c
N88# 29 d
M88#28 a
M88#29 b
M88#30 b
M88#31 a
M88#32 d
M88#33 c
M88#35 a

V. Government Regulation of Business

A. Regulation of Employment

M92#36 c
M92#37 d
M92#38 a
N91#32 c
N91#33 a
N91#34 b
M91#36 d
M91#37 c
M91#38 b
N90#36 b
N90#37 d
N90#38 c
M90#26 b
M90#27 d
N89#30 d
N89#31 c
N89#32 c
M89#36 c
M89#37 d
M89#38 c
N88#30 a
M88#43 c
M88#44 a
M88#45 b

B. Federal Securities Acts

M92#39 a
M92#40 d
M92#41 c
M92#42 b
M92#43 b
M92#44 a
M92#45 d
N91#27 b
N91#35 b
N91#36 b
N91#37 d
N91#39 d
N91#40 a
N91#41 d
M91#39 a
M91#40 d
M91#41 c
M91#42 c
M91#44 c
M91#45 c
M91#46 c
N90#39 b
N90#40 a
N90#41 c
N90#42 d
N90#43 d
N90#44 c
N90#45 a
M90#28 a
M90#29 c
M90#30 a
M90#31 b
M90#32 c
M90#33 a
M90#34 c
M90#37 d
N89#33 a
N89#34 d
N89#35 b
N89#36 d
N89#37 a
N89#38 d
N89#39 a
M89#40 d
M89#41 b
M89#42 a
M89#43 a
M89#44 c
M89#45 c
N88#31 a
N88#32 b
N88#33 d
N88#34 c
M88#36 c
M88#37 a
M88#38 a
M88#39 c
M88#40 c
M88#42 b

VI. Uniform Commercial Code

A. Commercial Paper

M92#46 d
M92#47 d
M92#48 c
N91#46 a
N91#47 c
N91#48 c
N91#49 d
N91#50 c
N90#46 d
N90#47 c
N90#48 a
N90#49 b
M90#35 a
M90#36 b
M90#38 a
M90#39 c
M90#41 d
N89#40 c
N89#41 c
N89#42 d
N89#43 c
N89#44 c
M89#46 a
M89#48 b
M89#49 a
M89#52 c
M89#59 b
N88#35 b
N88#36 a
N88#37 c
N88#38 d
N88#39 a
N88#40 d
N88#41 d
M88#46 d
M88#47 d
M88#48 d

B. Documents of Title and Investment Securities

M92#49 a
M92#50 d
M91#47 c
N90#50 d
N88#42 b
M88#49 a

C. Sales

M92#51 c
M92#52 c
M92#53 d
M92#54 c
M92#55 b
M92#56 a
M92#57 a
M92#58 b
M92#59 b
M92#60 a
M91#43 d
M91#48 c
M91#49 c
M91#50 a
M91#51 a
M91#52 d
M91#53 b
M91#54 d
M91#55 a
M91#56 a
M90#40 c
M90#42 c
M90#43 a
M90#44 d
M90#45 c
M90#46 c
M90#47 b
N89#45 a
N89#46 a
N89#47 c
N89#48 a
N89#49 d
N89#51 d
N89#52 a
M89#54 c
M89#55 d
M89#56 b
M89#57 c
M89#58 b
N88#43 c
N88#44 d
N88#45 a
N88#46 d
N88#47 d
N88#48 d
N88#49 b
N88#50 d
N88#51 d
M88#50 d

D. Secured Transactions

M91#57 c
M91#58 d
M91#59 d
M91#60 c
M90#49 a
M90#51 b
N89#50 a
N89#53 c
N89#54 a
N89#55 d
M89#47 c
M89#60 a
N88#52 b
N88#53 a
N88#54 a
N88#55 b

VII. Property

A. Real and Personal Property

N91#51 c
N91#52 d
N91#53 b
N91#54 b
N90#51 b
N90#52 d
N90#53 b
N90#56 d
M90#50 c
M90#52 d
M90#53 a
M90#54 c
M90#55 b
N89#56 c
N88#56 a
N88#57 c
N88#58 c
M88#51 b
M88#53 d
M88#54 a
M88#55 c

B. Mortgages

N91#55 d
N91#56 a
N91#57 a
N91#58 b
N90#54 a
N90#55 c
N90#58 a
N90#59 d
M90#56 b
M90#57 d
M90#58 b
N89#57 c
N89#58 a
N88#59 c
N88#60 c
M88#52 b
M88#56 a
M88#57 b

C. Fire and Casualty Insurance

N91#59 c
N91#60 c
N90#57 a
N90#60 c
M90#59 c
M90#60 d
N89#59 a
N89#60 c
M88#59 b
M88#60 a

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VII. Property

B. Mortgages

M92
Number 2 (Estimated time — — 15 to 20 minutes)

Instructions

Question Number 2 consists of 18 items. Select the **best** answer for each item. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Answer all items.** Your grade will be based on the total number of correct answers.

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

Item

Select from List A the order in which one goes through school in the United States.

99. First school attended.

List A
a. High School
b. College
c. Elementary School

Answer Sheet

Item	List A (select one)
99	(A) (B) ●

On June 10, 1990, Bond sold real property to Edwards for $100,000. Edwards assumed the $80,000 recorded mortgage Bond had previously given to Fair Bank and gave a $20,000 purchase money mortgage to Heath Finance. Heath did not record this mortgage. On December 15, 1991, Edwards sold the property to Ivor for $115,000. Ivor bought the property subject to the Fair mortgage but did not know about the Heath mortgage. Ivor borrowed $50,000 from Knox Bank and gave Knox a mortgage on the property. Knox knew of the unrecorded Heath mortgage when its mortgage was recorded. Ivor, Edwards, and Bond defaulted on the mortgages. Fair, Heath, and Knox foreclosed and the property was sold at a judicial foreclosure sale for $60,000. At the time of the sale, the outstanding balance of principal and accrued interest on the Fair mortgage was $75,000. The Heath mortgage balance was $18,000 and the Knox mortgage was $47,500.

Fair, Heath, and Knox all claim that their mortgages have priority and should be satisfied first from the sale proceeds. Bond, Edwards, and Ivor all claim that they are not liable for any deficiency resulting from the sale.

The above transactions took place in a jurisdiction that has a notice-race recording statute and allows foreclosure deficiency judgments.

Required:

a. Items 61 through 63. For each mortgage, select from List A the priority of that mortgage and blacken the corresponding oval on the Objective Answer Sheet. Blacken (A) if the mortgage has first priority, blacken (B) if the mortgage has second priority, and blacken (C) if the mortgage has third priority. A priority should be selected only once.

61. Knox Bank.
62. Heath Finance.
63. Fair Bank.

List A
a. First Priority.
b. Second Priority.
c. Third Priority.

b. Items 64 through 66. For each mortgage, select from List B the reason for its priority and blacken the corresponding oval on the Objective Answer Sheet. A reason may be selected once, more than once, or not at all.

64. Knox Bank.
65. Heath Finance.
66. Fair Bank.

List B

a. An unrecorded mortgage has priority over any subsequently recorded mortgage.
b. A recorded mortgage has priority over any unrecorded mortgage.
c. The first recorded mortgage has priority over all subsequent mortgages.
d. An unrecorded mortgage has priority over a subsequently recorded mortgage if the subsequent mortgagee knew of the unrecorded mortgage.
e. A purchase money mortgage has priority over a previously recorded mortgage.

---

c. Items 67 through 69. For each mortgage, select from List C the amount of the sale proceeds that each mortgagee would be entitled to receive and blacken the corresponding oval on the Objective Answer Sheet. An amount may be selected once, more than once, or not at all.

67. Knox Bank.
68. Heath Finance.
69. Fair Bank.

List C

a. $0.
b. $12,500.
c. $18,000.
d. $20,000.
e. $42,000.
f. $47,500.
g. $60,000.

---

d. Items 70 through 72. Determine whether each party would be liable to pay a mortgage foreclosure deficiency judgment on the Fair Bank mortgage. If the party would be held liable, select from List D the reason for the party's liability and blacken the corresponding oval on the Objective Answer Sheet. If you determine there is **no** liability, blacken (D) on the Objective Answer Sheet. A reason may be selected once, more than once, or not at all.

70. Edwards.
71. Bond.
72. Ivor.

List D

a. Original mortgagor.
b. Assumed the mortgage.
c. Took subject to the mortgage.
d. Not liable.

---

e. For items 73 through 75, determine whether each party would be liable to pay a mortgage foreclosure deficiency judgment on the Heath Finance mortgage. If the party would be held liable, select from List E the reason for that party's liability and blacken the corresponding oval on the Objective Answer Sheet. If you determine there is **no** liability, blacken (D) on the Objective Answer Sheet. A reason may be selected once, more than once, or not at all.

73. Edwards.
74. Bond.
75. Ivor.

List E

a. Original mortgagor.
b. Assumed the mortgage.
c. Took subject to the mortgage.
d. Not liable.

---

f. For items 76 through 78, determine whether each party would be liable to pay a mortgage foreclosure deficiency judgment on the Knox Bank mortgage. If the party would be held liable, select from List F the reason for that party's liability and blacken the corresponding oval on the Objective Answer Sheet. If you determine there is **no** liability, blacken (D) on the Objective Answer Sheet. A reason may be selected once, more than once, or not at all.

76. Edwards.
77. Bond.
78. Ivor.

List F

a. Original mortgagor.
b. Assumed the mortgage.
c. Took subject to the mortgage.
d. Not liable.

VII. Property

B. Mortgages

M92
Answer 2 (10 points)

ANSWER 2

Item	List A (select one)	Item	List D (select one)
61	Ⓐ Ⓑ ●	70	Ⓐ ● Ⓒ Ⓓ
62	Ⓐ ● Ⓒ	71	● Ⓑ Ⓒ Ⓓ
63	● Ⓑ Ⓒ	72	Ⓐ Ⓑ Ⓒ ●
Item	**List B (select one)**	**Item**	**List E (select one)**
64	Ⓐ Ⓑ Ⓒ ● Ⓔ	73	● Ⓑ Ⓒ Ⓓ
65	Ⓐ Ⓑ Ⓒ ● Ⓔ	74	Ⓐ Ⓑ Ⓒ ●
66	Ⓐ Ⓑ ● Ⓓ Ⓔ	75	Ⓐ Ⓑ Ⓒ ●
Item	**List C (select one)**	**Item**	**List F (select one)**
67	● Ⓑ Ⓒ Ⓓ Ⓔ Ⓕ Ⓖ	76	Ⓐ Ⓑ Ⓒ ●
68	● Ⓑ Ⓒ Ⓓ Ⓔ Ⓕ Ⓖ	77	Ⓐ Ⓑ Ⓒ ●
69	Ⓐ Ⓑ Ⓒ Ⓓ Ⓔ Ⓕ ●	78	● Ⓑ Ⓒ Ⓓ

I. The CPA and the Law

M92
Number 3 (Estimated time —— 15 to 20 minutes)

Goodwin, a CPA, and Jensen, a banker, were the trustees of the Moore Family Trust. The trust was created as a spendthrift trust and provided for distribution of income annually to the four Moore adult children for life, with the principal to be distributed to their issue after the death of the last income beneficiary. The trust was funded with commercial and residential real estate and a stock portfolio.

Goodwin, in addition to being a trustee, was lawfully employed as the trust's accountant. Goodwin, as the trust's accountant, prepared and signed all trust tax returns, kept the trust's accounting records, and supervised distributions to the income beneficiaries.

In 1990, Goodwin and Jensen, as trustees, sold a building owned by the trust for $400,000, its fair market value. The building had been valued at $250,000 when acquired by the trust. The $150,000 gain was allocated to income. In addition, the trust had rental, interest, and dividend income of $1,500,000 in 1990. Expenses for taxes, replacement of plumbing fixtures, roof repairs, utilities, salaries, and fees and commissions totaled $1,050,000.

On December 31, 1990, Goodwin and Jensen prepared and signed four $150,000 trust account checks and sent three of them to three of the income beneficiaries and the fourth one to a creditor of the fourth beneficiary. This beneficiary had acknowledged that the creditor was owed $200,000.

In February 1991, Goodwin discovered that Jensen had embezzled $200,000 by secretly selling part of the trust's stock portfolio. Goodwin agreed not to reveal Jensen's embezzlement if Jensen would pay Goodwin $25,000.

In April 1991, Goodwin prepared the 1990 trust income tax return. The return was signed by Goodwin as preparer and by Jensen and Goodwin as trustees and was filed with the IRS. Goodwin also prepared the 1990 income tax returns for the income beneficiaries. In an attempt to hide the embezzlement, Goodwin, in preparing the trust tax return, claimed nonexistent losses and improper credits. The beneficiaries' returns reflected the same nonexistent losses and improper credits. Consequently, the beneficiaries' taxes were underpaid. As a result of an IRS audit, the embezzlement was uncovered, the nonexistent losses and improper credits were disallowed, and the beneficiaries were assessed additional taxes, penalties, and interest.

Jensen cannot be located.

As a result of the above, the income beneficiaries sued Goodwin for negligence, fraud, and breach of fiduciary duty.

Required:
Answer the following questions and give the reasons for your conclusions.

Will the income beneficiaries win their suits against Goodwin for:

a. accountant's negligence?

b. actual fraud?

c. breach of fiduciary duty as a trustee?

M91
Number 5 (Estimated time —— 15 to 20 minutes)

Sleek Corp. is a public corporation whose stock is traded on a national securities exchange. Sleek hired Garson Associates, CPAs, to audit Sleek's financial statements. Sleek needed the audit to obtain bank loans and to make a public stock offering so that Sleek could undertake a business expansion program.

Before the engagement, Fred Hedge, Sleek's president, told Garson's managing partner that the audited financial statements would be submitted to Sleek's banks to obtain the necessary loans.

During the course of the audit, Garson's managing partner found that Hedge and other Sleek officers had embezzled substantial amounts of money from the corporation. These embezzlements threatened Sleek's financial stability. When these findings were brought to Hedge's attention, Hedge promised that the money would be repaid and begged that the audit not disclose the embezzlements.

Hedge also told Garson's managing partner that several friends and relatives of Sleek's officers had been advised about the projected business expansion and proposed stock offering, and had purchased significant amounts of Sleek's stock based on this information.

Garson submitted an unqualified opinion on Sleek's financial statements, which did not include adjustments for or disclosures about the embezzlements and insider stock transactions. The financial statements and audit report were submitted to Sleek's regular banks including Knox Bank. Knox, relying on the financial statements and Garson's report, gave Sleek a $2,000,000 loan.

Sleek's audited financial statements were also incorporated in a registration statement prepared under the provisions of the Securities Act of 1933. The registration statement was filed with the SEC in conjunction with Sleek's public offering of 100,000 shares of its common stock at $100 per share.

An SEC investigation of Sleek disclosed the embezzlements and the insider trading. Trading in Sleek's stock was suspended and Sleek defaulted on the Knox loan.

As a result, the following legal actions were taken:

- Knox sued Garson.
- The general public purchasers of Sleek's stock offerings sued Garson.

Required:
Answer the following questions and give the reasons for your conclusions.

a. Would Knox recover from Garson for fraud?

b. Would the general public purchasers of Sleek's stock offerings recover from Garson

1. Under the liability provisions of Section 11 of the Securities Act of 1933?
2. Under the anti-fraud provisions of Rule 10b-5 of the Securities Exchange Act of 1934?

M90
Number 3 (Estimated time —— 15 to 20 minutes)

Astor Electronics, Inc. is engaged in the business of marketing a wide variety of computer-related products throughout the United States. Astor's officers decided to raise $1,000,000 by selling shares of Astor's common stock in an exempt offering under Regulation D of the Securities Act of 1933. In connection with the offering, Astor engaged Apple & Co., CPAs, to audit Astor's 1989 financial statements. The audited financial statements, including Apple's unqualified opinion, were included in the offering memorandum given to prospective purchasers of Astor's stock. Apple was aware that Astor intended to include the statements in the offering materials.

On Astor's financial statements, certain inventory items were reported at a cost of $930,000 when, in fact, they had a fair market value of less than $100,000 because of technological obsolescence. Apple accepted the assurances of Astor's controller that cost was the appropriate valuation, despite the fact that Apple was aware of ongoing sales of the products at prices substantially less than cost. All of this was thoroughly documented in Apple's working papers.

Musk purchased 10,000 shares of Astor's common stock in the Regulation D offering at a total price of $300,000. In deciding to make the purchase, Musk had reviewed the audited financial statements of Astor that accompanied the other offering materials and Musk was impressed by Astor's apparent financial strength.

Shortly after the stock offering was completed, Astor's management discovered that the audited financial statements reflected the materially overstated valuation of the company's inventory. Astor advised its shareholders of the problem.

Musk, upon receiving notice from Astor of the overstated inventory amount, became very upset because the stock value was now substantially less than what it would have been had the financial statements been accurate. In fact, the stock is worth only about $200,000.

Musk has commenced an action against Apple alleging that Apple is liable to Musk based on the following causes of action:

- Common law fraud.
- Negligence.
- A violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

During the course of the litigation, Apple has refused to give to Musk its working papers pertaining to the Astor audit, claiming that these constituted privileged communications. The state in which the actions have been commenced has no accountants' privileged communication statute.

The state law applicable to this action follows the *Ultramares* decision with respect to accountants' liability to third parties for negligence or fraud.

Apple has also asserted that the actions should be dismissed because of the absence of any contractual relationship between Apple and Musk, i.e., a lack of privity.

Required:
Answer the following, setting forth reasons for any conclusions stated.

a. Will Apple be required to give Musk its working papers?

b. What elements must be established by Musk to support his cause of action based on negligence?

c. What elements must be established by Musk to support his cause of action based on a Rule 10b-5 violation?

d. Is Apple's assertion regarding lack of privity correct with regard to Musk's causes of action for negligence and fraud?

N89
Number 3 (Estimated time —— 15 to 20 minutes)

Astor Inc. purchased the assets of Bell Corp. A condition of the purchase agreement required Bell to retain a CPA to audit Bell's financial statements. The purpose of the audit was to determine whether the unaudited financial statements furnished to Astor fairly presented Bell's financial position. Bell retained Salam & Co., CPAs, to perform the audit.

While performing the audit, Salam discovered that Bell's bookkeeper had embezzled $500. Salam had some evidence of other embezzlements by the bookkeeper. However, Salam decided that the $500 was immaterial and that the other suspected embezzlements did not require further investigation. Salam did not discuss the matter with Bell's management. Unknown to Salam, the bookkeeper had, in fact, embezzled large sums of cash from Bell. In addition, the accounts receivable were significantly overstated. Salam did not detect the overstatement because of Salam's inadvertent failure to follow its audit program.

Despite the foregoing, Salam issued an unqualified opinion on Bell's financial statements and furnished a copy of the audited financial statements to Astor. Unknown to Salam, Astor required financing to purchase Bell's assets and furnished a copy of Bell's audited financial statements to City Bank to obtain approval of the loan. Based on Bell's audited financial statements, City loaned Astor $600,000.

Astor paid Bell $750,000 to purchase Bell's assets. Within six months, Astor began experiencing financial difficulties resulting from the undiscovered embezzlements and overstated accounts receivable. Astor later defaulted on the City loan.

City has commenced a lawsuit against Salam based on the following causes of action:

- Constructive fraud
- Negligence

Required: In separate paragraphs, discuss whether City is likely to prevail on the causes of action it has raised, setting forth reasons for each conclusion.

N88
Number 5 (Estimated time —— 15 to 20 minutes)

In order to expand its operations, Dark Corp. raised $4 million by making a private interstate offering of $2 million in common stock and negotiating a $2 million loan from Safe Bank. The common stock was properly offered pursuant to Rule 505 of Regulation D.

In connection with this financing, Dark engaged Crea & Co., CPAs, to audit Dark's financial statements. Crea knew that the sole purpose for the audit was so that Dark would have audited financial statements to provide to Safe and the purchasers of the common stock. Although Crea conducted the audit in conformity with its audit program, Crea failed to detect material acts of embezzlement committed by Dark's president. Crea did not detect the embezzlement because of its inadvertent failure to exercise due care in designing its audit program for this engagement.

After completing the audit, Crea rendered an unqualified opinion on Dark's financial statements. The financial statements were relied upon by the purchasers of the common stock in deciding to purchase the shares. In addition, Safe approved the loan to Dark based on the audited financial statements.

Within 60 days after the sale of the common stock and the making of the loan by Safe, Dark was involuntarily petitioned into bankruptcy. Because of the president's embezzlement, Dark became insolvent and defaulted on its loan to Safe. Its common stock became virtually worthless. Actions have been commenced against Crea by:

- The purchasers of the common stock who have asserted that Crea is liable for damages under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934.

- Safe, based upon Crea's negligence.

Required: In separate paragraphs, discuss the merits of the actions commenced against Crea, indicating the likely outcomes and the reasons therefor.

M88
Number 5 (Estimated time —— 15 to 20 minutes)

Birk Corp. is interested in acquiring Apple & Co. Birk engaged Kaye & Co., CPAs, to audit the 1987 financial statements of Apple. Both Birk and Apple are engaged in the business of providing management consulting services. While reviewing certain contracts entered into by Apple, Kaye became concerned with the proper reporting of the following matters:

- On December 5, 1987, Apple entered into an oral agreement with Cream Inc., to perform certain management advisory services for Cream for a fee of $150,000 per month. The services were to have commenced on February 15, 1988, and to have ended on December 20, 1988. Apple reported all of the revenues related to the contract on its 1987 financial statements. This constituted 30% of Apple's income for 1987.

- On February 8, 1987, Apple purchased the assets of Nestar & Co., a small management consulting firm. Apple and Nestar entered into a written agreement with regard to the transaction that required Apple to pay Nestar $80,000 a year for five years. The agreement required Nestar to transfer all of its assets and goodwill to Apple. Further, the agreement required Nestar not to compete with Apple or Apple's successors for a period of three years within the city where the majority of Nestar's clients were located. Nestar's office was also located in this city. Other Nestar clients were located throughout the state.

On February 1, 1988, Birk acquired all of Apple's outstanding stock. Birk's decision was based on the unqualified opinion issued by Kaye on Apple's 1987 financial statements. Within 10 days after the merger, Cream decided not to honor the agreement with Apple and gave notice that it had selected another management consulting firm. This caused the market value of the Apple stock acquired by Birk to decrease drastically.

On May 2, 1987, Birk learned that Nestar opened a management consulting firm three blocks from where Nestar's office had been located on February 8, 1987.

Based on the foregoing, Birk has commenced an action against Kaye alleging negligence in performing the audit of Apple's financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss whether the December 5, 1987, agreement between Cream and Apple is enforceable.

b. Discuss whether the agreement of Nestar not to compete with Apple is enforceable against Nestar.

c. Discuss whether Birk will prevail in its action against Kaye & Co., CPAs.

II. Business Organizations

A. Agency

N90
Number 3 (Estimated time —— 15 to 20 minutes)

Prime Cars, Inc. buys and sells used automobiles. Occasionally Prime has its salespeople purchase used cars from third parties without disclosing that the salesperson is in fact buying for Prime's used car inventory. Prime's management believes better prices can be negotiated using this procedure. One of Prime's salespeople, Peterson, entered into a contract with Hallow in accordance with instructions from Prime's sales manager. The car was to be delivered one week later. After entering into the contract with Hallow, and while driving back to Prime's place of business, Peterson was involved in an automobile accident with another vehicle. Peterson's negligence, and the resulting collision, injured Mathews, the driver of the other car involved in the accident.

Prime terminated Peterson's employment because of the accident. Following Prime's general business practices, Prime published an advertisement in several trade journals that gave notice that Peterson was no longer employed by Prime. Shortly thereafter, Peterson approached one of Prime's competitors, Bagley Autos, Inc., and contracted to sell Bagley several used cars in Prime's inventory. Bagley's sales manager, who frequently purchased cars out of Prime's inventory from Peterson, paid 25% of the total price to Peterson, with the balance to be paid ten days later when the cars were to be delivered. Bagley's sales manager was unaware of Peterson's termination. Prime refused to deliver the cars to Bagley or to repay Bagley's down payment, which Prime never received from Peterson.

Prime also refused to go through with the contract entered into by Peterson with Hallow. Mathews sued both Peterson and Prime for the injuries sustained in the automobile accident. Bagley sued Prime for failing to deliver the cars or return the down payment paid to Peterson.

Required:
Answer each of the following questions, setting forth the reasons for your conclusions.

a. What rights does Hallow have against Prime or Peterson?

b. Will Mathews prevail in the lawsuit against Prime and Peterson?

c. Will Bagley prevail in its lawsuit against Prime?

B. Partnerships and Joint Ventures

M91
Number 2 (Estimated time —— 15 to 20 minutes)

Prime Cars Partnership is a general partnership engaged in the business of buying, selling, and servicing used cars. Prime's original partners were Baker and Mathews, who formed the partnership three years ago under a written partnership agreement, which provided that:

- Profits and losses would be allocated 60% to Baker and 40% to Mathews.
- Baker would be responsible for supervising Prime's salespeople and for purchasing used cars for inventory. Baker could not, without Mathews' consent, enter into a contract to purchase more than $15,000 worth of used cars at any one time.
- Mathews would be responsible for supervising Prime's service department.

On May 1, 1990, Baker entered into a contract on Prime's behalf with Jaco Auto Wholesalers, Inc. to purchase 11 used cars from Jaco for a total purchase price of $40,000. Baker's agreement with Jaco provided that the cars would be delivered to Prime on September 1. Baker did not advise Mathews of the terms and conditions of the contract with Jaco. Baker had regularly done business with Jaco on behalf of Prime in the past, and on several occasions had purchased $12,000 to $15,000 of used cars from Jaco. Jaco was unaware of the limitation on Baker's authority.

Baker also frequently purchased used cars for Prime from Top Auto Auctions, Ltd., a corporation owned by Baker's friend. Whenever Prime purchased cars from Top, Baker would personally receive up to 5% of the total purchase price from Top as an incentive to do more business with Top. Baker did not tell Mathews about these payments.

On August 1, 1990, Baker and Mathews agreed to admit KYA Auto Restorers, Inc. as a partner in Prime to start up and supervise a body shop facility. KYA made a $25,000 capital contribution and Prime's partnership agreement was amended to provide that Prime's profits and losses would be shared equally by the partners.

On September 1, 1990, Mathews learned of the Jaco contract and refused to accept delivery of the cars. Mathews advised Jaco that Baker had entered into the contract without Mathews' consent as required by their agreement. Jaco has demanded a payment of $10,000 from Prime for Jaco's lost profits under the contract.

Mathews has also learned about the incentive payments made to Baker by Top.

Mathews has taken the following positions:

- Prime is not liable to Jaco because Baker entered into the contract without Mathews' consent.
- In any event, Mathews is not liable to Jaco for more than 40% of Jaco's lost profits because of the original partnership provisions concerning the sharing of profits and losses.
- Baker is liable to Mathews for any liability incurred by Mathews under the Jaco contract.
- Baker is liable to Prime for accepting the incentive payments from Top.

KYA contends that none of its $25,000 capital contribution should be applied to the Jaco liability and that, in any event, KYA does not have any responsibility for the obligation.

Required:

a. State whether Mathews' positions are correct and give the reasons for your conclusions.

b. State whether KYA's contentions are correct and give the reasons for your conclusions.

M90
Number 4 (Estimated time —— 15 to 20 minutes)

Smith, Edwards, and Weil formed Sterling Properties Limited Partnership to engage in the business of buying, selling and managing real estate. Smith and Edwards were general partners. Weil was a limited partner entitled to 50% of all profits.

Within a few months of Sterling's formation, it became apparent to Weil that Smith's and Edwards' inexperience was likely to result in financial disaster for the partnership. Therefore, Weil became more involved in day-to-day management decisions. Weil met with prospective buyers and sellers of properties; assisted in negotiating partnership loans with its various lenders; and took an active role in dealing with personnel problems. Things continued to deteriorate for Sterling, and the partners began blaming each other for the partnership's problems.

Finally, Smith could no longer deal with the situation, and withdrew from the partnership. Edwards reminded Smith that the Sterling partnership agreement specifically prohibited withdrawal by a general partner without the consent of all the other partners. Smith advised Edwards and Weil that she would take no part in any further partnership undertaking and would not be responsible for partnership debts incurred after this withdrawal.

With Sterling on the verge of collapse, the following situations have occurred:

- Weil demanded the right to inspect and copy the partnership's books and records and Edwards refused to allow Weil to do so, claiming that Weil's status as a limited partner precludes that right.
- Anchor Bank, which made a loan to the partnership prior to Smith's withdrawal, is suing Sterling and each partner individually, including Smith, because the loan is in default. Weil denied any liability based on his limited partner status. Smith denies liability based on her withdrawal.
- Edwards sued Smith for withdrawing from the partnership and is uncertain about the effect of her withdrawal on the partnership.
- Weil wants to assign his partnership interest to Fred Alberts, who wants to become a substitute limited partner. Weil is uncertain about his right to assign this interest to Alberts and, further, the right of Alberts to become a substitute limited partner. Edwards contends that Edwards' consent is necessary for the assignment or the substitution of Alberts as a limited partner and that without this consent any such assignment would cause a dissolution of the partnership. The Sterling partnership agreement and certificate are silent in this regard.

Required:

Answer the following questions, setting forth reasons for the conclusions stated.

a. Is Weil entitled to inspect and copy the books and records of the partnership?

b. Are Weil and/or Smith liable to Anchor Bank?

c. Will Edwards prevail in the lawsuit against Smith for withdrawing from the partnership?

d. What is the legal implication to the partnership of Smith's withdrawal?

e. Can Weil assign his partnership interest to Alberts?

f. Can Edwards prevent the assignment to Alberts or the substitution of Alberts as a limited partner?

g. What rights does Alberts have as assignee of Weil's partnership interest?

h. What effect does an assignment have on the partnership?

N88
Number 4 (Estimated time —— 15 to 20 minutes)

On January 5, Stein, Rey, and Lusk entered into a written general partnership agreement by which they agreed to operate a stock brokerage firm. The agreement stated that the partnership would continue upon the death or withdrawal of a partner. The agreement also provided that no partner could reduce the firm's commission below 2% without the consent of all of the other partners. On March 10, Rey, without the consent of Stein and Lusk, agreed with King Corp. to reduce the commission to 1½% on a large transaction by King. Rey believed this would entice King to become a regular customer of the firm. King was unaware of any of the terms of the partnership agreement.

On May 15, Stein entered into a contract conveying Stein's partnership interest to Park and withdrew from the partnership. That same day, all of the partners agreed to admit Park as a general partner. Notice of Stein's withdrawal and Park's admission as a partner was properly published in two newspapers. In addition, third parties who had conducted business with the partnership prior to May 15 received written notice of Stein's withdrawal.

Required:
a. In separate paragraphs, discuss whether:
1. The partnership could recover the ½% commission from King.
2. The partnership could recover the ½% commission from Rey.

b. In separate paragraphs, discuss:
1. Park's liability for partnership obligations arising both before and after being admitted to the partnership.
2. Stein's liability for partnership obligations arising both before and after withdrawing from the partnership.

M88
Number 3 (Estimated time —— 15 to 20 minutes)

Walsh is evaluating two different investment opportunities. One requires an investment of $100,000 to become a limited partner in a limited partnership that owns a shopping center. The other requires an investment of $100,000 to purchase 3% of the voting common stock of a corporation engaged in manufacturing. Walsh is uncertain about the advantages and disadvantages of being a limited partner versus being a shareholder. The issues of most concern to Walsh are:

- The right to transfer a limited partnership interest versus shares of stock.
- The liability as a limited partner versus that of a shareholder for debts incurred by a limited partnership or a corporation.
- The right of a limited partner versus that of a shareholder to participate in daily management.
- The right of a limited partner to receive partnership profits versus the right of a shareholder to receive dividends from a corporation.

Required: Briefly identify and discuss the basic differences and similarities in the formation of a limited partnership and a corporation. Discuss in separate paragraphs the issues raised by Walsh. (Ignore tax and securities laws.)

C. Corporations

N91
Number 2 (Estimated time —— 15 to 20 minutes)

Frost, Glen, and Bradley own 50%, 40%, and 10%, respectively, of the authorized and issued voting common stock of Xeon Corp. They had a written stockholders' agreement that provided they would vote for each other as directors of the corporation.

At the initial stockholders' meeting, Frost, Glen, Bradley, and three others were elected to a six-person board of directors. The board elected Frost as president of the corporation, Glen as secretary, and Bradley as vice president. Frost and Glen were given two-year contracts with annual salaries of $50,000. Bradley was given a two-year contract for $10,000 per year.

At the end of its first year of operation, Xeon was in financial difficulty. Bradley disagreed with the way Frost and Glen were running the business.

At the annual stockholders' meeting, a new board of directors was elected. Bradley was excluded because Frost and Glen did not vote for Bradley. Without cause, the new board fired Bradley as vice president even though 12 months remained on Bradley's contract.

Despite the corporation's financial difficulties, the new board, relying on the assurances of Frost and Glen and based on fraudulent documentation provided by Frost and Glen, declared and paid a $200,000 dividend. Payment of the dividend caused the corporation to become insolvent.

- Bradley sued Frost and Glen to compel them to follow the written stockholders' agreement and re-elect Bradley to the board.

- Bradley sued the corporation to be reinstated as an officer of the corporation, and for breach of the employment contract.

- Bradley sued each member of the board for declaring and paying an unlawful dividend, and demanded its repayment to the corporation.

Required:
State whether Bradley would be successful in each of the above suits and give the reasons for your conclusions.

N89
Number 5 (Estimated time —— 15 to 20 minutes)

On May 12, 1987, West purchased 6% of Ace Corp.'s outstanding $3 cumulative preferred stock and 7% of Ace's outstanding common stock. These are the only two classes of stock authorized by Ace's charter. Both classes of stock are traded on a national stock exchange. Ace uses the calendar year for financial reporting purposes.

During 1987 and 1988, Ace neither declared dividends nor recorded dividends in arrears as a liability on its books. West was disturbed about this and, on February 8, 1989, sent a written demand to examine Ace's books and records to determine Ace's financial condition. Ace has refused to permit West to examine its books and records.

On May 8, 1989, West lost the stock certificate representing the shares of preferred stock. On May 9, 1989, West notified Ace of the lost stock certificate and requested that Ace issue a new stock certificate. West offered to file an indemnity bond with Ace and to fulfill any reasonable requests made by Ace. Although Ace has no knowledge that any other party has acquired the lost stock certificate, Ace refused to issue a new stock certificate or accept the indemnity bond.

As a result of the foregoing, West has made the following assertions:

- Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability that, in effect, would treat West as a general creditor to the extent of the dividends in arrears.
- West is entitled to examine Ace's books and records.
- West is entitled to receive a new stock certificate to replace the lost stock certificate.

Required: In separate paragraphs, discuss West's assertions. Indicate whether such assertions are correct and the reasons therefor. Do **not** consider securities laws.

M89
Number 4 (Estimated time —— 15 to 20 minutes)

On May 1, 1987, Cray's board of directors unanimously voted to have Cray reacquire 100,000 shares of its common stock. On May 25, 1987, Cray did so, paying current market price. In determining whether to reacquire the shares, the board of directors relied on reports and financial statements that were negligently prepared by Cray's internal accounting department under the supervision of the treasurer and reviewed by its independent accountants. The reports and financial statements indicated that, as of April 30, 1987, Cray was solvent and there were sufficient funds to reacquire the shares. Subsequently, it was discovered that Cray had become insolvent in March 1987 and continued to be insolvent after the reacquisition of the shares. As a result of the foregoing, Cray experienced liquidity problems and losses during 1987 and 1988.

The board of directors immediately fired the treasurer because of the treasurer's negligence in supervising the preparation of the reports and financial statements. The treasurer had three years remaining on a binding five-year employment agreement which, among other things, prohibited the termination of the treasurer's employment for mere negligence.

Required: Discuss the following assertions, indicating whether such assertions are correct and the reasons therefor.

- It was improper for the board of directors to authorize the reacquisition of Cray's common stock while Cray was insolvent.
- The members of the board of directors are personally liable because they voted to reacquire shares while Cray was insolvent.
- Cray will be liable to the treasurer as a result of his termination by the board of directors.

N88
Number 3 (Estimated time —— 15 to 20 minutes)

Maple owns 75% of the common stock of Salam Exterminating, Inc. Maple is not an officer or employee of the corporation, and does not serve on its board of directors. Salam is in the business of providing exterminating services to residential and commercial customers.

Dodd performed exterminating services on behalf of Salam. Dodd suffered permanent injuries as a result of inhaling one of the chemicals used by Salam. This occurred after Dodd sprayed the chemical in a restaurant that Salam regularly services. Dodd was under the supervision of one of Salam's district managers and was trained by Salam to perform exterminating services following certain procedures, which he did. Later that day several patrons who ate at the restaurant also suffered permanent injuries as a result of inhaling the chemical. The chemical was manufactured by Ace Chemical Corp. and sold and delivered to Salam in a closed container. It was not altered by Salam. It has now been determined that the chemical was defectively manufactured and the injuries suffered by Dodd and the restaurant patrons were a direct result of the defect.

Salam has complied with an applicable compulsory workers' compensation statute by obtaining an insurance policy from Spear Insurance Co.

As a result of the foregoing, the following actions have been commenced:

- Dodd sued Spear to recover workers' compensation benefits.
- Dodd sued Salam based on negligence in training him.
- Dodd sued Ace based on strict liability in tort.
- The restaurant patrons sued Maple claiming negligence in not preventing Salam from using the chemical purchased from Ace.

Required: Discuss the merits of the actions commenced by Dodd and the restaurant patrons, indicating the likely outcomes and your reasons therefor.

M88
Number 3 (Estimated time —— 15 to 20 minutes)

Walsh is evaluating two different investment opportunities. One requires an investment of $100,000 to become a limited partner in a limited partnership that owns a shopping center. The other requires an investment of $100,000 to purchase 3% of the voting common stock of a corporation engaged in manufacturing. Walsh is uncertain about the advantages and disadvantages of being a limited partner versus being a shareholder. The issues of most concern to Walsh are:

- The right to transfer a limited partnership interest versus shares of stock.
- The liability as a limited partner versus that of a shareholder for debts incurred by a limited partnership or a corporation.
- The right of a limited partner versus that of a shareholder to participate in daily management.
- The right of a limited partner to receive partnership profits versus the right of a shareholder to receive dividends from a corporation.

Required: Briefly identify and discuss the basic differences and similarities in the formation of a limited partnership and a corporation. Discuss in separate paragraphs the issues raised by Walsh. (Ignore tax and securities laws.)

D. Estates and Trusts

M92
Number 3 (Estimated time —— 15 to 20 minutes)

Goodwin, a CPA, and Jensen, a banker, were the trustees of the Moore Family Trust. The trust was created as a spendthrift trust and provided for distribution of income annually to the four Moore adult children for life, with the principal to be distributed to their issue after the death of the last income beneficiary. The trust was funded with commercial and residential real estate and a stock portfolio.

Goodwin, in addition to being a trustee, was lawfully employed as the trust's accountant. Goodwin, as the trust's accountant, prepared and signed all trust tax returns, kept the trust's accounting records, and supervised distributions to the income beneficiaries.

In 1990, Goodwin and Jensen, as trustees, sold a building owned by the trust for $400,000, its fair market value. The building had been valued at $250,000 when acquired by the trust. The $150,000 gain was allocated to income. In addition, the trust had rental, interest, and dividend income of $1,500,000 in 1990. Expenses for taxes, replacement of plumbing fixtures, roof repairs, utilities, salaries, and fees and commissions totaled $1,050,000.

On December 31, 1990, Goodwin and Jensen prepared and signed four $150,000 trust account checks and sent three of them to three of the income beneficiaries and the fourth one to a creditor of the fourth beneficiary. This beneficiary had acknowledged that the creditor was owed $200,000.

In February 1991, Goodwin discovered that Jensen had embezzled $200,000 by secretly selling part of the trust's stock portfolio. Goodwin agreed not to reveal Jensen's embezzlement if Jensen would pay Goodwin $25,000.

In April 1991, Goodwin prepared the 1990 trust income tax return. The return was signed by Goodwin as preparer and by Jensen and Goodwin as trustees and was filed with the IRS. Goodwin also prepared the 1990 income tax returns for the income beneficiaries. In an attempt to hide the embezzlement, Goodwin, in preparing the trust tax return, claimed nonexistent losses and improper credits. The beneficiaries' returns reflected the same nonexistent losses and improper credits. Consequently, the beneficiaries' taxes were underpaid. As a result of an IRS audit, the embezzlement was uncovered, the nonexistent losses and improper credits were disallowed, and the beneficiaries were assessed additional taxes, penalties, and interest.

Jensen cannot be located.

As a result of the above, the income beneficiaries sued Goodwin for negligence, fraud, and breach of fiduciary duty.

Required:
Answer the following questions and give the reasons for your conclusions.

Will the income beneficiaries win their suits against Goodwin for:

a. accountant's negligence?

b. actual fraud?

c. breach of fiduciary duty as a trustee?

N89
Number 2 (Estimated time —— 15 to 20 minutes)

On May 1, 1988, Mary Stein sold a commercial building to Sam Bean and Bean's son, Bob, as equal tenants in common. At the time of the sale, there was a recorded existing mortgage on the building in favor of Fale Bank. The mortgage and the note it secured were silent as to whether the entire amount outstanding on the loan would become due upon the sale of the building. Sam and Bob did not assume the mortgage and it was not paid off when they purchased the building.

On June 15, 1989, Sam died leaving a will naming his wife, Rita Bean, as the beneficiary of his entire estate, except for certain stocks which were to be transferred to a spendthrift trust created for the benefit of Bob. The will named Rita as the trustee and Bob as the sole beneficiary of the trust. The provision in the will creating the spendthrift trust stated in part that:

> Payments and distributions to the beneficiary shall be made only to the beneficiary in person or upon his personal receipt, and no interest of the beneficiary in the income or principal of the trust estate shall be assignable in anticipation of payment, either by the voluntary or involuntary act of the beneficiary or by operation of law, or be liable in any way for the debts of the beneficiary.

Required:

a. Discuss the personal liability of Sam Bean and Bob Bean, and the personal liability of Mary Stein, if there is a default on the mortgage to Fale and a foreclosure sale results in a deficiency.

b. Discuss the effect Sam Bean's death will have on the ownership of the building.

c. Discuss the major purposes/benefits of a spendthrift trust such as the one created by Sam Bean.

d. Discuss whether

1. A trust may generally be terminated by its beneficiaries; and
2. The spendthrift trust created by Sam Bean could be terminated by Bob Bean.

III. Contracts

N91
Number 3 (Estimated time —— 15 to 20 minutes)

In a signed letter dated March 2, 1991, Stake offered to sell Packer a specific vacant parcel of land for $100,000. Stake had inherited the land, along with several apartment buildings in the immediate vicinity. Packer received the offer on March 4. The offer required acceptance by March 10 and required Packer to have the property surveyed by a licensed surveyor so the exact legal description of the property could be determined.

On March 6, Packer sent Stake a counteroffer of $75,000. All other terms and conditions of the offer were unchanged. Stake received Packer's counteroffer on March 8, and, on that day, telephoned Packer and accepted it. On learning that a survey of the vacant parcel would cost about $1,000, Packer telephoned Stake on March 11 requesting that they share the survey cost equally. During this conversation, Stake agreed to Packer's proposal.

During the course of the negotiations leading up to the March communications between Stake and Packer, Stake expressed concern to Packer that a buyer of the land might build apartment units that would compete with those owned by Stake in the immediate vicinity. Packer assured Stake that Packer intended to use the land for a small shopping center. Because of these assurances, Stake was willing to sell the land to Packer. Contrary to what Packer told Stake, Packer had already contracted conditionally with Rolf for Rolf to build a 48-unit apartment development on the vacant land to be purchased from Stake.

During the last week of March, Stake learned that the land to be sold to Packer had a fair market value of $200,000. Also, Stake learned that Packer intended to build apartments on the land. Because of this information, Stake sued Packer to rescind the real estate contract, alleging that:

- Packer committed fraud in the formation of the contract thereby entitling Stake to rescind the contract.
- Stake's innocent mistake as to the fair market value of the land entitles Stake to rescind the contract.
- The contract was not enforceable against Stake because Stake did not sign Packer's March 6 counteroffer.

Required:

State whether Stake's allegations are correct and give the reasons for your conclusions.

N90

Number 2 (Estimated time —— 15 to 20 minutes)

The following letters were mailed among Jacobs, a real estate developer, Snow, the owner of an undeveloped parcel of land, and Eljay Distributors, Inc., a clothing wholesaler interested in acquiring Snow's parcel to build a warehouse:

a. *January 21, 1990* — Snow to Jacobs: "My vacant parcel (Lot 2, Birds Addition to Cedar Grove) is available for $125,000 cash; closing within 60 days. You must accept by January 31 if you are interested."

   This was received by Jacobs on January 31.

b. *January 29, 1990* — Snow to Jacobs: "Ignore my January 21 letter to you; I have decided not to sell my lot at this time."

   This was received by Jacobs on February 3.

c. *January 31, 1990* — Jacobs to Snow: "Per your January 21 letter, you have got a deal."

   Jacobs inadvertently forgot to sign the January 31 letter, which was received by Snow on February 4.

d. *February 2, 1990* — Jacobs to Eljay: "In consideration of your promise to pay me $10,000, I hereby assign to you my right to purchase Snow's vacant lot (Lot 2, Birds Addition to Cedar Grove)."

   This was received by Eljay on February 5.

All of the letters were signed, except as noted above, and properly stamped and addressed.

Snow has refused to sell the land to Jacobs or Eljay, asserting that no contract exists because:

- Jacobs' acceptance was not received on a timely basis.
- Snow had revoked the January 21 offer.
- Jacobs' acceptance was not signed.
- Jacobs had no right to assign the contract to Eljay.

Required:

For each of Snow's assertions, indicate whether the assertion is correct, setting forth reasons for your conclusion.

N89

Number 4 (Estimated time —— 15 to 20 minutes)

Anker Corp., a furniture retailer, engaged Best & Co., CPAs, to audit Anker's financial statements for the year ended December 31, 1988. While reviewing certain transactions entered into by Anker during 1988, Best became concerned with the proper reporting of the following transactions:

- On September 8, 1988, Crisp Corp., a furniture manufacturer, signed and mailed a letter offering to sell Anker 50 pieces of furniture for $9,500. The offer stated it would remain open until December 20, 1988. On December 5, 1988, Crisp mailed a letter revoking this offer. Anker received Crisp's revocation the following day. On December 12, 1988, Anker mailed its acceptance to Crisp, and Crisp received it on December 13, 1988.
- On December 6, 1988, Dix Corp. signed and mailed a letter offering to sell Anker a building for $75,000. The offer stated that acceptance could only be made by certified mail, return receipt requested. On December 10, 1988, Anker telephoned Dix requesting that Dix keep the offer open until December 20, 1988 because it was reviewing Dix's offer. On December 12, 1988, Dix signed and mailed a letter to Anker indicating that it would hold the offer open until December 20, 1988. On December 19, 1988, Anker sent its acceptance to Dix by a private express mail courier. Anker's acceptance was received by Dix on December 20, 1988.

After reviewing the documents concerning the foregoing transactions, Best spoke with Anker's president who made the following assertions:

- The September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and therefore a contract was formed by Anker's acceptance on December 12, 1988.
- Dix's letter dated December 12, 1988 formed an option contract with Anker.
- Anker's acceptance on December 19, 1988 formed a contract with Dix.

Required: In separate paragraphs, discuss the assertions made by Anker's president. Indicate whether the assertions are correct and the reasons therefor.

N88

Number 2 (Estimated time —— 15 to 20 minutes)

Dunn & Co., CPAs, while performing the 1987 year-end audit of Starr Corp.'s financial statements discovered that certain events during 1987 had resulted in litigation.

Starr had purchased the warehouse on March 1, 1987. The contract between Birk and Starr provided for a closing on September 20, 1987. On July 1, 1987, Birk executed a contract to purchase the warehouse from Starr for $200,000. On September 1, 1987, Birk contacted Starr and demanded that the purchase price be reduced to $190,000 because of a sudden rise in interest rates and declining value of real estate. Starr orally agreed to change the price to $190,000. On September 2, Birk sent Starr a signed memo confirming the reduction in price to $190,000. Starr did not sign the memo or any other agreement reducing the price. On September 15, Starr, by telephone, informed Birk that it would not sell the warehouse for $190,000. Birk refused to pay Starr $200,000 and a closing never occurred.

On October 30, 1987, a fire caused $80,000 damage to the warehouse at a time when its fair market value was $200,000. Starr had obtained a $160,000 fire insurance policy on February 15, 1987, from Pica Casualty Co., covering the warehouse. On April 11, 1987, Starr obtained another fire insurance policy from Drake Insurance Co. covering the warehouse for $40,000. Each policy contained an 80% coinsurance clause and a provision limiting each company's liability to its proportion of all insurance covering the loss. Pica has refused to pay any amount on its policy.

Starr commenced actions against Birk and Pica asserting the following:

- Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of $200,000.

- Starr has an insurable interest in the warehouse covered under the policy with Pica.

- Starr has met the coinsurance requirement under Pica's policy.

- Starr is entitled to recover the entire $80,000 from Pica.

Required: Discuss Starr's assertions, indicating whether such assertions are correct and the reasons therefor.

M88
Number 5 (Estimated time —— 15 to 20 minutes)

Birk Corp. is interested in acquiring Apple & Co. Birk engaged Kaye & Co., CPAs, to audit the 1987 financial statements of Apple. Both Birk and Apple are engaged in the business of providing management consulting services. While reviewing certain contracts entered into by Apple, Kaye became concerned with the proper reporting of the following matters:

- On December 5, 1987, Apple entered into an oral agreement with Cream Inc., to perform certain management advisory services for Cream for a fee of $150,000 per month. The services were to have commenced on February 15, 1988 and to have ended on December 20, 1988. Apple reported all of the revenues related to the contract on its 1987 financial statements. This constituted 30% of Apple's income for 1987.

- On February 8, 1987, Apple purchased the assets of Nestar & Co., a small management consulting firm. Apple and Nestar entered into a written agreement with regard to the transaction that required Apple to pay Nestar $80,000 a year for five years. The agreement required Nestar to transfer all of its assets and goodwill to Apple. Further, the agreement required Nestar not to compete with Apple or Apple's successors for a period of three years within the city where the majority of Nestar's clients were located. Nestar's office was also located in this city. Other Nestar clients were located throughout the state.

On February 1, 1988, Birk acquired all of Apple's outstanding stock. Birk's decision was based on the unqualified opinion issued by Kaye on Apple's 1987 financial statements. Within 10 days after the merger, Cream decided not to honor the agreement with Apple and gave notice that it had selected another management consulting firm. This caused the market value of the Apple stock acquired by Birk to decrease drastically.

On May 2, 1987, Birk learned that Nestar opened a management consulting firm three blocks from where Nestar's office had been located on February 8, 1987.

Based on the foregoing, Birk has commenced an action against Kaye alleging negligence in performing the audit of Apple's financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss whether the December 5, 1987, agreement between Cream and Apple is enforceable.

b. Discuss whether the agreement of Nestar not to compete with Apple is enforceable against Nestar.

c. Discuss whether Birk will prevail in its action against Kaye & Co., CPAs.

B. Bankruptcy

M92
Number 4 (Estimated time —— 15 to 20 minutes)

Techno, Inc. is a computer equipment dealer. On February 3, 1992, Techno was four months behind in its payments to Allied Building Maintenance, Cleen Janitorial Services, Inc., and Jones and Associates, CPAs, all of whom provide monthly services to Techno. In an attempt to settle with these three creditors, Techno offered each of them a reduced lump-sum payment for the past due obligations and full payment for future services. These creditors rejected Techno's offer and on April 9, 1992, Allied, Cleen and Jones filed an involuntary petition in bankruptcy against Techno under the provisions of Chapter 7 of the Federal Bankruptcy Code. At the time of the filing, Techno's liability to the three creditors was $9,100, all of which was unsecured.

Techno, at the time of the filing, had liabilities of $229,000 (owed to 23 creditors) and assets with a fair market value of $191,000. During the entire year before the bankruptcy filing, Techno's liabilities exceeded the fair market value of its assets.

Included in Techno's liabilities was an installment loan payable to Dollar Finance Co., properly secured by cash registers and other equipment.

The bankruptcy court approved the involuntary petition.

On April 21, 1992, Dollar filed a motion for relief from automatic stay in bankruptcy court claiming it was entitled to take possession of the cash registers and other equipment securing its loan. Dollar plans to sell these assets immediately and apply the proceeds to the loan balance. The fair market value of the collateral is less than the loan balance and Dollar claims to lack adequate protection. Also, Dollar claims it is entitled to receive a priority distribution, before distribution to unsecured creditors, for the amount Techno owes Dollar less the proceeds from the sale of the collateral.

During the course of the bankruptcy proceeding, the following transactions were disclosed:

- On October 6, 1991, Techno paid its president $9,900 as repayment of an unsecured loan made to the corporation on September 18, 1989.
- On February 19, 1992, Techno paid $1,150 to Alexis Computers, Inc. for eight color computer monitors. These monitors were delivered to Techno on February 9, 1992, and placed in inventory.
- On January 12, 1992, Techno bought a new delivery truck from Maple Motors for $7,900 cash. On the date of the bankruptcy filing, the truck was worth $7,000.

Required:
Answer the following questions and give the reasons for your conclusions.

a. What circumstances had to exist to allow Allied, Cleen, and Jones to file an involuntary bankruptcy petition against Techno?

b. 1. Will Dollar's motion for relief be granted?
2. Will Dollar's claim for priority be approved by the bankruptcy court?

c. Are the payments to Techno's president, Alexis, and Maple preferential transfers?

M90
Number 2 (Estimated time —— 15 to 20 minutes)

On February 1, 1990, Drake, a sole proprietor operating a retail clothing store, filed a bankruptcy petition under the liquidation provisions of the Bankruptcy Code. For at least six months prior to the filing of the petition, Drake had been unable to pay current business and personal obligations as they came due. Total liabilities substantially exceeded the total assets. A trustee was appointed who has converted all of Drake's nonexempt property to cash in the amount of $96,000. Drake's bankruptcy petition reflects a total of $310,000 of debts, including the following:

- A judgment against Drake in the amount of $19,500 as a result of an automobile accident caused by Drake's negligence.
- Unpaid federal income taxes in the amount of $4,300 for the year 1983. (Drake filed an accurate tax return for 1983.)
- A $3,200 obligation payable on June 1, 1990, described as being owed to Martin Office Equipment, when, in fact, the debt is owed to Bartin Computer Supplies (Bartin has no knowledge of Drake's bankruptcy and the time for filing claims has expired).
- Unpaid child support in the amount of $780 arising from a support order incorporated in Drake's 1982 divorce judgment.

Prior to the filing of the petition, Drake entered into the following transactions:

- January 13, 1990 — paid Safe Bank $7,500, the full amount due on an unsecured loan given by Safe on November 13, 1989 (Drake had used the loan proceeds to purchase a family automobile).

- October 21, 1989 — conveyed to his brother, in repayment of a $2,000 debt, a painting that cost Drake $125 and which had a fair market value of $2,000.
- November 15, 1989 — borrowed $23,000 from Home Savings and Loan Association, giving Home a first mortgage on Drake's residence, which has a fair market value of $100,000.
- November 9, 1989 — paid $4,300 to Max Clothing Distributors for clothing delivered to Drake 60 days earlier (Drake had for several years purchased inventory from Max and his other suppliers on 60-day credit terms).

Required:

Answer the following questions, setting forth reasons for any conclusions stated.

a. Will the four debts described above be discharged in Drake's bankruptcy?

b. What factors must the bankruptcy trustee show to set aside a transaction as a preferential transfer?

c. State whether each transaction entered into by Drake is a preferential or non-preferential transfer.

M89

Number 2 (Estimated time —— 15 to 20 minutes)

On March 23, 1989, Tine, a sole proprietor, was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. The petition was filed by Lux, Squire, and Rusk, who were creditors of Tine with unsecured claims of $3,000, $4,000, and $2,000, respectively. Tine also has 10 other unsecured creditors, three partially secured creditors, and two fully secured creditors, none of whom joined in the filing of the bankruptcy petition. For the six-month period before the filing of the bankruptcy petition, Tine had been unable to pay current obligations as they became due. At the time the petition was filed, Tine had a negative net worth.

Before March 23, 1989, Tine entered into the following transactions:

- On December 29, 1988, Tine borrowed $250,000 from Safe Finance. On January 31, 1989, after learning of Tine's financial problems, Safe requested that Tine execute a mortgage on Tine's residence naming Safe as mortgagee. On January 31, 1989, Tine executed the mortgage and delivered it to Safe and it was recorded that same day. The residence had a fair market value of $300,000 at all times.
- On May 5, 1988, Rich Bank loaned Tine $50,000 based on Tine's personal financial statements. Tine knew the financial statements submitted to Rich substantially overstated Tine's net worth because of misrepresentations that were difficult to detect.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss whether the requirements necessary for the commencement of an involuntary bankruptcy proceeding were met.

b. Assuming that the requirements necessary for the commencement of an involuntary bankruptcy were met, discuss the following:

1. What action may the court take regarding the transactions between Tine and Safe?
2. What action may the court take regarding the transaction between Tine and Rich if Rich challenges the discharge of its debt?

V. Government Regulation of Business

A. Regulation of Employment

N88

Number 3 (Estimated time —— 15 to 20 minutes)

Maple owns 75% of the common stock of Salam Exterminating, Inc. Maple is not an officer or employee of the corporation, and does not serve on its board of directors. Salam is in the business of providing exterminating services to residential and commercial customers.

Dodd performed exterminating services on behalf of Salam. Dodd suffered permanent injuries as a result of inhaling one of the chemicals used by Salam. This occurred after Dodd sprayed the chemical in a restaurant that Salam regularly services. Dodd was under the supervision of one of Salam's district managers and was trained by Salam to perform exterminating services following certain procedures, which he did. Later that day several patrons who ate at the restaurant also suffered permanent injuries as a result of inhaling the chemical. The chemical was manufactured by Ace Chemical Corp. and sold and delivered to Salam in a closed container. It was not altered by Salam. It has now been determined that the chemical was defectively manufactured and the injuries suffered by Dodd and the restaurant patrons were a direct result of the defect.

Salam has complied with an applicable compulsory workers' compensation statute by obtaining an insurance policy from Spear Insurance Co.

As a result of the foregoing, the following actions have been commenced:

- Dodd sued Spear to recover workers' compensation benefits.
- Dodd sued Salam based on negligence in training him.
- Dodd sued Ace based on strict liability in tort.
- The restaurant patrons sued Maple claiming negligence in not preventing Salam from using the chemical purchased from Ace.

Required: Discuss the merits of the actions commenced by Dodd and the restaurant patrons, indicating the likely outcomes and your reasons therefor.

VI. Uniform Commercial Code

A. Commercial Paper

M92
Number 5 (Estimated time —— 15 to 20 minutes)

Rustic Equipment, Inc. manufactures lathes and other woodworking equipment. It sells these products to hardware stores, often on credit. Rustic usually requires its credit customers to place large signs in their stores indicating that Rustic products are made available through financing provided by Rustic.

On February 1, 1992, Rustic sold and delivered five lathes to Friendly Hardware Corp. for $25,000. Friendly sells woodworking tools and equipment, among other things, to the general public. Friendly made a 10% downpayment and delivered a promissory note for the balance, along with a security agreement and a financing statement covering the lathes. Rustic properly filed the financing statement on February 9, 1992. Rustic required Friendly to display a sign in its store indicating that Rustic provided financing for the lathes.

On February 6, 1992, Friendly borrowed $100,000 from National Bank, and gave National a promissory note, a security agreement, and a financing statement covering Friendly's inventory, fixtures, and equipment. Friendly intended to use the loan proceeds to remodel its store. National properly filed the financing statement on February 7, 1992. National was not aware of Rustic's security interest in the lathes included in Friendly's inventory.

On March 8, 1992, Friendly sold one of the Rustic lathes to Karry, whose hobby was woodworking. Karry paid 20% of the purchase price, and gave Friendly a promissory note for the balance and a security agreement covering the lathe. Karry, at the time of the purchase, saw the sign publicizing the financing arrangement between Rustic and Friendly. Friendly did not file a financing statement.

The following is the promissory note Karry gave to Friendly:

> March 8 , 199 2
>
> I promise to pay Friendly Hardware Corp. or bearer $ 900.00 , with interest thereon at 12 % per annum.
>
> *S.J. Karry*
> Maker
>
> Reference: Sale of Lathe
> Invoice #6734

On March 10, 1992, Friendly delivered Karry's promissory note, without endorsement, to Queen Bank in exchange for $750. Queen, a holder in due course, was unaware that Karry had advised Friendly that the lathe was not operating properly and that Karry had no intention of paying the note. Queen then delivered the note to Abcor Factors, Inc. in exchange for $800. At the time Abcor acquired the note from Queen, it knew that Karry disputed any obligation under the note because the lathe was not working properly.

Friendly has experienced serious financial difficulties and defaulted on its obligations to Rustic and National. Abcor has demanded that Karry pay the note given to Friendly, but Karry has refused to do so.

Rustic and Karry have taken the following positions:

- Rustic claims that its security interest in the lathes, including the one sold to Karry, is superior to that of National and that Karry purchased the lathe subject to Rustic's security interest.

- Karry refuses to honor the note held by Abcor claiming that:

  It is nonnegotiable because it is not payable at a definite time and it references the sales invoice.

  Abcor has no rights under the note because it was not endorsed by Friendly.

  Abcor was aware of Karry's claim that the lathe was not working properly and, therefore, took the note subject to that claim.

Required:
State whether the claims of Rustic and Karry are correct and give the reasons for your conclusions.

M91
Number 3 (Estimated time —— 15 to 20 minutes)

River Oaks is a wholesale distributor of automobile parts. River Oaks received the promissory note shown below from First Auto, Inc., as security for payment of a $4,400 auto parts shipment. When River Oaks accepted the note as collateral for the First Auto obligation, River Oaks was aware that the maker of the note, Hillcraft, Inc., was claiming that the note was unenforceable because Alexco Co. had breached the license agreement under which Hillcraft had given the note. First Auto had acquired the note from Smith in exchange for repairing several cars owned by Smith. At the time First Auto received the note, First Auto was unaware of the dispute between Hillcraft and Alexco. Also, Smith, who paid Alexco $3,500 for the note, was unaware of Hillcraft's allegations that Alexco had breached the license agreement.

PROMISSORY NOTE

Date: 1/14/90

Hillcraft, Inc. promises to pay to Alexco Co. or bearer the sum of $4,400 Four Thousand and 00/100 Dollars on or before May 15, 1991 (maker may elect to extend due date by 30 days) with interest thereon at the rate of 9½% per annum.

Hillcraft, Inc.
By: *P.J. Hill*
P.J. Hill, President

Reference: Alexco Licensing Agreement

The reverse side of the note was endorsed as follows:

Pay to the order of First Auto without recourse

E. Smith
E. Smith

Pay to the order of River Oaks Co.

First Auto
By: *G. First*
G. First, President

First Auto is now insolvent and unable to satisfy its obligation to River Oaks. Therefore, River Oaks has demanded that Hillcraft pay $4,400, but Hillcraft has refused, asserting:

- The note is nonnegotiable because it references the license agreement and is not payable at a definite time or on demand.
- River Oaks is not a holder in due course of the note because it received the note as security for amounts owed by First Auto.
- River Oaks is not a holder in due course because it was aware of the dispute between Hillcraft and Alexco.
- Hillcraft can raise the alleged breach by Alexco as a defense to payment.
- River Oaks has no right to the note because it was not endorsed by Alexco.
- The maximum amount that Hillcraft would owe under the note is $4,000, plus accrued interest.

Required:
State whether each of Hillcraft's assertions are correct and give the reasons for your conclusions.

M90
Number 5 (Estimated time —— 15 to 20 minutes)

On February 12, 1990, Mayfair & Associates, CPAs, was engaged to audit the financial statements of University Book Distributors, Inc. University operates as a retail and wholesale distributor of books, newspapers, magazines, and other periodicals. In conjunction with the audit of University's cash, notes, and accounts receivable, University's controller gave Mayfair's staff accountant certain instruments that University had received from its customers during 1989 in the ordinary course of its business. The instruments are:

- A signed promissory note dated June 30, 1989, in the amount of $3,100 payable "to Harris on

December 31, 1989." The maker of the note was Peters and it was indorsed in blank by Harris, who delivered it to University as payment for a shipment of magazines. University demanded that Peters pay the note but Peters refused, claiming that he gave the note as a result of misrepresentations by Harris related to a real estate transaction between the two of them. University advised Harris immediately of Peters' refusal to pay.

- A signed promissory note dated July 31, 1989, in the amount of $1,800 payable "to the order of Able on January 15, 1990." The maker of the note was Cole and it further provided that it was given "pursuant to that certain construction contract dated June 1, 1989." The note had been given to University as payment for books by one of its customers, Baker, who did not indorse it. The note bears Able's blank indorsement. University demanded payment from Cole. Cole refused to honor the note claiming that:

  - The note's reference to the construction contract renders it nonnegotiable; and
  - University has no rights to the note because it was not indorsed by Baker.

University immediately advised Baker of Cole's refusal to pay.

University is uncertain of its rights under the two notes.

Required:

Answer the following questions, setting forth reasons for your conclusions.

a. With regard to the note executed by Peters, is University a holder in due course?

b. Can Peters raise Harris' alleged misrepresentations as a defense to University's demand for payment?

c. Are Cole's claims valid?

B. Documents of Title and Investment Securities

N89
Number 5 (Estimated time —— 15 to 20 minutes)

On May 12, 1987, West purchased 6% of Ace Corp.'s outstanding $3 cumulative preferred stock and 7% of Ace's outstanding common stock. These are the only two classes of stock authorized by Ace's charter. Both classes of stock are traded on a national stock exchange. Ace uses the calendar year for financial reporting purposes.

During 1987 and 1988, Ace neither declared dividends nor recorded dividends in arrears as a liability on its books. West was disturbed about this and, on February 8, 1989, sent a written demand to examine Ace's books and records to determine Ace's financial condition. Ace has refused to permit West to examine its books and records.

On May 8, 1989, West lost the stock certificate representing the shares of preferred stock. On May 9, 1989, West notified Ace of the lost stock certificate and requested that Ace issue a new stock certificate. West offered to file an indemnity bond with Ace and to fulfill any reasonable requests made by Ace. Although Ace has no knowledge that any other party has acquired the lost stock certificate, Ace refused to issue a new stock certificate or accept the indemnity bond.

As a result of the foregoing, West has made the following assertions:

- Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability that, in effect, would treat West as a general creditor to the extent of the dividends in arrears.
- West is entitled to examine Ace's books and records.
- West is entitled to receive a new stock certificate to replace the lost stock certificate.

Required: In separate paragraphs, discuss West's assertions. Indicate whether such assertions are correct and the reasons therefor. Do **not** consider securities laws.

C. Sales

N91
Number 4 (Estimated time —— 15 to 20 minutes)

On October 10, Vesta Electronics contracted with Zap Audio to sell Zap 200 18″ stereo speakers. The contract provided that the speakers would be shipped F.O.B. seller's loading dock. The contract was silent as to when risk of loss for the speakers would pass to Zap. Delivery was to be completed by November 10.

On October 18, Vesta identified the speakers to be shipped to Zap and moved them to the loading dock. Before the carrier picked up the goods, a fire on Vesta's loading dock destroyed 50 of the speakers. On October 20, Vesta shipped, by common carrier, the remaining 150 18″ speakers and 50 16″ speakers. The truck carrying the speakers was involved in an accident resulting in damage to 25 of the 16″ speakers. Zap received the 200 speakers on October 25, and on October 27 notified Vesta that 100 of the 18″ speakers were being accepted but the rest of the shipment was being rejected. Zap also informed Vesta that, due to Vesta's failure to comply with the terms of the contract, Zap would contest paying the contract price and would sue for damages.

The above parties and transactions are subject to the Uniform Commercial Code (UCC).

Required:

Answer the following questions, and give the reasons for your conclusions.

a. 1. Who bears the risk of loss for the 50 destroyed 18″ speakers?

2. Who bears the risk of loss for the 25 damaged 16″ speakers?

b. 1. Was Zap's rejection of the 16″ speakers valid?

2. Was Zap's acceptance of some of the 18″ speakers valid?

c. Under the UCC, what duties are required of Zap after rejecting all or part of the shipment?

N90
Number 4 (Estimated time —— 15 to 20 minutes)

Pharo Aviation, Inc. sells and services used airplanes. Sanders, Pharo's service department manager, negotiated with Secure Equipment Co. for the purchase of a used tug for moving airplanes in and out of Pharo's hangar. Secure sells and services tugs and related equipment. Sanders was unfamiliar with the various models, specifications, and capacities of the tugs sold by Secure; however, Sanders knew that the tug purchased needed to have the capacity to move airplanes weighing up to 10,000 pounds. Sanders and the sales representative discussed this specific need because Sanders was uncertain as to which tug would meet Pharo's requirements. The sales representative then recommended a particular make and model of tug. Sanders agreed to rely on the sales representative's advice and signed a purchase contract with Secure.

About a week after Sanders took delivery, the following occurred:

- Sanders determined that the tug did not have the capacity to move airplanes weighing over 5,000 pounds.
- Sanders was advised correctly by Maco Equipment Distributors, Inc. that Maco was the rightful owner of the tug, which it had left with Secure for repairs.

Pharo has commenced a lawsuit against Secure claiming that implied warranties were created by the contract with Secure and that these have been breached. Maco has claimed that it is entitled to the tug and has demanded its return from Pharo.

Required:
Answer each of the following questions, and set forth the reasons for your conclusions.

a. Were any implied warranties created by the contract between Pharo and Secure and, if so, were any of those warranties breached?

b. Is Maco entitled to the return of the tug?

N89
Number 4 (Estimated time —— 15 to 20 minutes)

Anker Corp., a furniture retailer, engaged Best & Co., CPAs, to audit Anker's financial statements for the year ended December 31, 1988. While reviewing certain transactions entered into by Anker during 1988, Best became concerned with the proper reporting of the following transactions:

- On September 8, 1988, Crisp Corp., a furniture manufacturer, signed and mailed a letter offering to sell Anker 50 pieces of furniture for $9,500. The offer stated it would remain open until December 20, 1988. On December 5, 1988, Crisp mailed a letter revoking this offer. Anker received Crisp's revocation the following day. On December 12, 1988, Anker mailed its acceptance to Crisp, and Crisp received it on December 13, 1988.
- On December 6, 1988, Dix Corp. signed and mailed a letter offering to sell Anker a building for $75,000. The offer stated that acceptance could only be made by certified mail, return receipt requested. On December 10, 1988, Anker telephoned Dix requesting that Dix keep the offer open until December 20, 1988 because it was reviewing Dix's offer. On December 12, 1988, Dix signed and mailed a letter to Anker indicating that it would hold the offer open until December 20, 1988. On December 19, 1988, Anker sent its acceptance to Dix by a private express mail courier. Anker's acceptance was received by Dix on December 20, 1988.

After reviewing the documents concerning the foregoing transactions, Best spoke with Anker's president who made the following assertions:

- The September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and therefore a contract was formed by Anker's acceptance on December 12, 1988.
- Dix's letter dated December 12, 1988 formed an option contract with Anker.
- Anker's acceptance on December 19, 1988 formed a contract with Dix.

Required: In separate paragraphs, discuss the assertions made by Anker's president. Indicate whether the assertions are correct and the reasons therefor.

M89
Number 5 (Estimated time —— 15 to 20 minutes)

On February 20, 1989, Pine, Inc. ordered a specially manufactured computer system consisting of a disk drive and a central processing unit (CPU) from Xeon Corp., a seller of computers and other office equipment. A contract was signed and the total purchase price was paid to Xeon by Pine on the same date. The contract required Pine to pick up the computer system at Xeon's warehouse on March 9, 1989, but was silent as to when risk of loss passed to Pine. The computer system was completed on March 1, 1989, and set aside for Pine's contemplated pickup on March 9, 1989. On March 3, 1989, the disk drive was stolen from Xeon's warehouse. On March 9, 1989, Pine picked up the CPU. On March 15, 1989, Pine returned the CPU to Xeon for warranty repairs. On March 18, 1989, Xeon mistakenly sold the CPU to Meed, a buyer in the ordinary course of business.

On April 12, 1989, Pine purchased and received delivery of five word processors from Jensen Electronics Corp. for use in its business. The purchase price of the word processors was $15,000. Pine paid $5,000 down and executed an installment purchase note and a security agreement for the balance. The security agreement contained a description of the word processors. Jensen never filed a financing statement. On April 1, 1989, Pine had given its bank a security interest in all of its assets. The bank had immediately perfected its security interest by filing. Pine has defaulted on the installment purchase note.

Required: Discuss the following assertions, indicating whether such assertions are correct and the reasons therefor.

- As of March 3, 1989, the risk of loss on the disk drive remained with Xeon.
- Meed acquired no rights in the CPU as a result of the March 18, 1989, transaction.
- Jensen's security interest in the word processors never attached and therefore Jensen's security interest is not enforceable against Pine.
- Jensen has a superior security interest to Pine's bank.

N88
Number 3 (Estimated time —— 15 to 20 minutes)

Maple owns 75% of the common stock of Salam Exterminating, Inc. Maple is not an officer or employee of the corporation, and does not serve on its board of directors. Salam is in the business of providing exterminating services to residential and commercial customers.

Dodd performed exterminating services on behalf of Salam. Dodd suffered permanent injuries as a result of inhaling one of the chemicals used by Salam. This occurred after Dodd sprayed the chemical in a restaurant that Salam regularly services. Dodd was under the supervision of one of Salam's district managers and was trained by Salam to perform exterminating services following certain procedures, which he did. Later that day several patrons who ate at the restaurant also suffered permanent injuries as a result of inhaling the chemical. The chemical was manufactured by Ace Chemical Corp. and sold and delivered to Salam in a closed container. It was not altered by Salam. It has now been determined that the chemical was defectively manufactured and the injuries suffered by Dodd and the restaurant patrons were a direct result of the defect.

Salam has complied with an applicable compulsory workers' compensation statute by obtaining an insurance policy from Spear Insurance Co.

As a result of the foregoing, the following actions have been commenced:

- Dodd sued Spear to recover workers' compensation benefits.
- Dodd sued Salam based on negligence in training him.
- Dodd sued Ace based on strict liability in tort.
- The restaurant patrons sued Maple claiming negligence in not preventing Salam from using the chemical purchased from Ace.

Required: Discuss the merits of the actions commenced by Dodd and the restaurant patrons, indicating the likely outcomes and your reasons therefor.

M88
Number 2 (Estimated time —— 15 to 20 minutes)

Mirk & Co., CPAs, has been engaged to audit Spear Corp.'s 1987 financial statements. Spear is engaged in the business of buying and selling computers. Spear has adopted a calendar year for accounting purposes. While conducting the audit, Mirk reviewed the following transactions occurring in December 1987.

- On December 20, Spear sold five computers to Pica Corp. The contract required Spear to ship the computers by common carrier. The shipping terms of the contract were "F.O.B.—Spear's loading dock." The computers were shipped on December 30, and on January 1, 1988, while the computers were in transit, the common carrier was involved in an accident causing a fire that totally destroyed the computers. Pica discovered, upon a review of a copy of the common carrier's bill of lading, that the destroyed computers were not the models it had ordered.
- On December 21, Spear purchased and took delivery of 15 computers from Larson for $20,000. Larson had purchased the computers from Xeon Co., paying Xeon with a check that Larson's bank refused to honor because of insufficient funds. Spear was unaware that Larson's check was dishonored.
- On December 22, Spear entered into a sale on approval contract with Rusk Corp. for two computers. Rusk is engaged exclusively in the business of selling furniture. The contract required Rusk to notify Spear within 15 days after delivery if it did not want to keep the computers. Rusk took delivery of the computers on December 21, and, as of December 31, had not yet decided whether to keep the computers.

With regard to the transactions described above, Mirk wishes to resolve the following issues that were not addressed in the specific contracts:

As of December 31, 1987, which of the parties bears the risk of loss for the computers with regard to the:

- December 20 transaction with Pica?
- December 22 transaction with Rusk?

As of December 31, 1987, which of the parties has title to the computers with regard to the:

- December 21 transaction with Larson?
- December 22 transaction with Rusk?

What rights do the general creditors of Rusk have to the computers delivered to Rusk pursuant to the December 22 transaction with Spear?

Required: Discuss the issues raised by Mirk, setting forth your conclusions and reasons therefor.

D. Secured Transactions

M92
Number 5 (Estimated time —— 15 to 20 minutes)

Rustic Equipment, Inc. manufactures lathes and other woodworking equipment. It sells these products to hardware stores, often on credit. Rustic usually requires its credit customers to place large signs in their stores indicating that Rustic products are made available through financing provided by Rustic.

On February 1, 1992, Rustic sold and delivered five lathes to Friendly Hardware Corp. for $25,000. Friendly sells woodworking tools and equipment, among other things, to the general public. Friendly made a 10% downpayment and delivered a promissory note for the balance, along with a security agreement and a financing statement covering the lathes. Rustic properly filed the financing statement on February 9, 1992. Rustic required Friendly to display a sign in its store indicating that Rustic provided financing for the lathes.

On February 6, 1992, Friendly borrowed $100,000 from National Bank, and gave National a promissory note, a security agreement, and a financing statement covering Friendly's inventory, fixtures, and equipment. Friendly intended to use the loan proceeds to remodel its store. National properly filed the financing statement on February 7, 1992. National was not aware of Rustic's security interest in the lathes included in Friendly's inventory.

On March 8, 1992, Friendly sold one of the Rustic lathes to Karry, whose hobby was woodworking. Karry paid 20% of the purchase price, and gave Friendly a promissory note for the balance and a security agreement covering the lathe. Karry, at the time of the purchase, saw the sign publicizing the financing arrangement between Rustic and Friendly. Friendly did not file a financing statement.

The following is the promissory note Karry gave to Friendly:

> March 8 , 199 2
>
> I promise to pay Friendly Hardware Corp. or bearer $ 900.00 , with interest thereon at 12 % per annum.
>
> *S.J. Karry*
> Maker
>
> Reference: Sale of Lathe
> Invoice #6734

On March 10, 1992, Friendly delivered Karry's promissory note, without endorsement, to Queen Bank in exchange for $750. Queen, a holder in due course, was unaware that Karry had advised Friendly that the lathe was not operating properly and that Karry had no intention of paying the note. Queen then delivered the note to Abcor Factors, Inc. in exchange for $800. At the time Abcor acquired the note from Queen, it knew that Karry disputed any obligation under the note because the lathe was not working properly.

Friendly has experienced serious financial difficulties and defaulted on its obligations to Rustic and National. Abcor has demanded that Karry pay the note given to Friendly, but Karry has refused to do so.

Rustic and Karry have taken the following positions:

- Rustic claims that its security interest in the lathes, including the one sold to Karry, is superior to that of National and that Karry purchased the lathe subject to Rustic's security interest.
- Karry refuses to honor the note held by Abcor claiming that:

  It is nonnegotiable because it is not payable at a definite time and it references the sales invoice.

  Abcor has no rights under the note because it was not endorsed by Friendly.

  Abcor was aware of Karry's claim that the lathe was not working properly and, therefore, took the note subject to that claim.

Required:
State whether the claims of Rustic and Karry are correct and give the reasons for your conclusions.

N91
Number 5 (Estimated time —— 15 to 20 minutes)

Mead, a junior member of a CPA firm's audit staff, was assigned to assist in auditing Abco Electronics, Inc.'s financial statements. Abco sells various brands of computer equipment to the general public, and to distributors who sell the equipment to retail customers for personal and business use. One of Mead's assignments was to evaluate the following transactions:

- On September 1, Abco sold a CDM computer out of its inventory to Rice, who intended to use it for business purposes. Rice paid 25% of the purchase price and executed and delivered to Abco a promissory note for the balance. A security agreement was signed only by the Abco sales representative. Abco failed to file a financing statement. Rice is in default under the promissory note. Rice claimed that Abco does not have an effective security interest in the computer because Rice did not sign the security agreement, and because Abco did not file a financing statement.

- On August 18, Abco sold a computer to Baker, who intended to use it for business inventory and accounts payable control, and payroll processing. Baker paid 20% of the purchase price and executed and delivered to Abco a promissory note for the balance and a security agreement covering the computer. Abco filed a financing statement on August 27. On August 25, Baker borrowed $5,000 from Condor Finance Co., giving Condor a promissory note for the loan amount and a security agreement covering the computer. Condor filed a financing statement on August 26. Baker defaulted on the promissory note given to Abco and its obligation to Condor. Condor has asserted that its security interest in the computer is superior to Abco's.

Required:

State whether the claims of Rice and Condor are correct and give the reasons for your conclusions.

N90

Number 5 (Estimated time —— 15 to 20 minutes)

Wizard Computer Co. sells computers to the general public. On April 30, Wizard financed the purchase of its computer inventory with National Bank. Wizard executed and delivered a promissory note and a security agreement covering the inventory. National filed a financing statement on the same day.

On May 1, Wizard sold a computer out of its inventory to Kast, who intended to use it to do some household budgeting. Kast made a 10% down payment toward the purchase price. Kast executed and delivered to Wizard a promissory note for the balance and a security agreement covering the computer. Kast was aware that Wizard financed its inventory with National. Wizard did not file a financing statement.

On May 6, Kast, who was dissatisfied with the computer, sold it on credit to Marc, who intended to use it to assist in family budgeting. Marc, who was unaware that Kast had purchased the computer on credit, paid 25% of the purchase price and executed and delivered to Kast a promissory note for the balance and a security agreement covering the computer. Kast did not file a financing statement.

On May 12, Marc borrowed $6,000 from Alcor Finance. Marc gave Alcor a promissory note for the loan amount and a security agreement covering the computer and other household appliances owned by Marc. Alcor did not file a financing statement.

Marc failed to pay Alcor or Kast. In turn, Kast has been unable to pay Wizard. On June 2, Wizard defaulted on its obligation to National.

Kast and Marc take the following positions:

- Kast asserts that the computer was purchased from Wizard free of National's security interest.
- Marc asserts that the computer was purchased from Kast free of Wizard's security interest.
- Marc asserts that Alcor's security interest is unenforceable against Marc because Alcor failed to file a financing statement.

Required:

For each assertion, indicate whether it is correct, and set forth the reasons for your conclusion.

M88

Number 4 (Estimated time —— 15 to 20 minutes)

Dunn & Co., CPAs, is auditing the 1987 financial statements of its client, Safe Finance. While performing the audit, Dunn learned of certain transactions that occurred during 1987 that may have an adverse impact on Safe's financial statements. The following transactions are of most concern to Dunn:

- On May 5, Safe sold certain equipment to Lux, who contemporaneously executed and delivered to Safe a promissory note and security agreement covering the equipment. Lux purchased the equipment for use in its business. On May 8, City Bank loaned Lux $50,000, taking a promissory note and security agreement from Lux that covered all of Lux's existing and after-acquired equipment. On May 11, Lux was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code and a trustee was appointed. On May 12, City filed a financing statement covering all of Lux's equipment. On May 14, Safe filed a financing statement covering the equipment it had sold to Lux on May 5.

- On July 10, Safe loaned $600,000 to Cam Corp., which used the funds to refinance existing debts. Cam duly executed and delivered to Safe a promissory note and a security agreement covering Cam's existing and after-acquired inventory of machine parts. On July 12, Safe filed a financing statement covering Cam's inventory of machine parts. On July 15, Best Bank loaned Cam $200,000. Contemporaneous with the loan, Cam executed and delivered to Best a promissory note and security agreement covering all of Cam's inventory of machine parts and any after-acquired inventory. Best had already filed a financing statement covering Cam's inventory on June 20, after Best agreed to make the loan to Cam. On July 14, Dix, in good faith, purchased certain machine parts from Cam's inventory and received delivery that same day.

Required: Define a purchase money security interest. In separate paragraphs, discuss whether Safe has a priority security interest over:

- The trustee in Lux's bankruptcy with regard to the equipment sold by Safe on May 5.
- City with regard to the equipment sold by Safe on May 5.
- Best with regard to Cam's existing and after-acquired inventory of machine parts.
- Dix with regard to the machine parts purchased on July 14 by Dix.

VII. Property

A. Real and Personal Property

N89
Number 2 (Estimated time —— 15 to 20 minutes)

On May 1, 1988, Mary Stein sold a commercial building to Sam Bean and Bean's son, Bob, as equal tenants in common. At the time of the sale, there was a recorded existing mortgage on the building in favor of Fale Bank. The mortgage and the note it secured were silent as to whether the entire amount outstanding on the loan would become due upon the sale of the building. Sam and Bob did not assume the mortgage and it was not paid off when they purchased the building.

On June 15, 1989, Sam died leaving a will naming his wife, Rita Bean, as the beneficiary of his entire estate, except for certain stocks which were to be transferred to a spendthrift trust created for the benefit of Bob. The will named Rita as the trustee and Bob as the sole beneficiary of the trust. The provision in the will creating the spendthrift trust stated in part that:

> Payments and distributions to the beneficiary shall be made only to the beneficiary in person or upon his personal receipt, and no interest of the beneficiary in the income or principal of the trust estate shall be assignable in anticipation of payment, either by the voluntary or involuntary act of the beneficiary or by operation of law, or be liable in any way for the debts of the beneficiary.

Required:

a. Discuss the personal liability of Sam Bean and Bob Bean, and the personal liability of Mary Stein, if there is a default on the mortgage to Fale and a foreclosure sale results in a deficiency.

b. Discuss the effect Sam Bean's death will have on the ownership of the building.

c. Discuss the major purposes/benefits of a spendthrift trust such as the one created by Sam Bean.

d. Discuss whether

1. A trust may generally be terminated by its beneficiaries; and
2. The spendthrift trust created by Sam Bean could be terminated by Bob Bean.

M89
Number 3 (Estimated time —— 15 to 20 minutes)

On March 2, 1988, Ash, Bale, and Rangel purchased an office building from Park Corp. as joint tenants with right of survivorship. There was an outstanding note and mortgage on the building, which they assumed. The note and mortgage named Park as the mortgagor (borrower) and Vista Bank as the mortgagee (lender). Vista has consented to the assumption.

Wein, Inc., a tenant in the office building, had entered into a 10-year lease dated May 8, 1985. The lease was silent regarding Wein's right to sublet. The lease provided for Wein to take occupancy on June 1, 1985, and that the monthly rent would be $5,000 for the entire 10-year term. On March 10, 1989, Wein informed Ash, Bale, and Rangel that it had agreed to sublet its office space to Nord Corp. On March 17, 1989, Ash, Bale, and Rangel notified Wein of their refusal to consent to the sublet. The following assertions have been made:

- The sublet from Wein to Nord is void because Ash, Bale, and Rangel did not consent.
- If the sublet is not void, Ash, Bale, and Rangel have the right to hold either Wein or Nord liable for payment of the rent.

On April 4, 1989, Ash transferred his interest in the building to his spouse.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. *For this item only,* assume that Ash, Bale, and Rangel default on the mortgage note, that Vista forecloses, and a deficiency results. Discuss the personal liability of Ash, Bale, and Rangel to Vista and the personal liability of Park to Vista.

b. Discuss the assertions as to the sublet, indicating whether such assertions are correct and the reasons therefor.

c. *For this item only,* assume that Ash and Rangel died on April 20, 1989. Discuss the ownership interest(s) in the office building as of April 5, 1989, and April 21, 1989.

B. Mortgages

M91
Number 4 (Estimated time —— 15 to 20 minutes)

On February 1, 1988, Tower and Perry, as tenants in common, purchased a two-unit apartment building for $250,000. They made a down payment of $100,000, and gave a $100,000 first mortgage to Midway Bank and a $50,000 second mortgage to New Bank.

New was aware of Midway's mortgage but, as a result of a clerical error, Midway did not record its mortgage until after New's mortgage was recorded.

At the time of purchase, a $200,000 fire insurance policy was issued by Acme Insurance Co. to Tower and Perry. The policy contained an 80% coinsurance clause and a standard mortgagee provision.

Tower and Perry rented an apartment to Young under a month-to-month oral lease. They rented the other apartment to Zimmer under a three-year written lease.

On December 8, 1989, Perry died leaving a will naming the Dodd Foundation as the sole beneficiary of Perry's estate. The estate was distributed on January 15, 1990. That same date, the ownership of the fire insurance policy was assigned to Tower and Dodd with Acme's consent. On January 21, 1990, a fire caused $180,000 in structural damage to the building. At that time, its market value was $300,000 and the Midway mortgage balance was $80,000 including accrued interest. The New mortgage balance was $40,000 including accrued interest.

The fire made Young's apartment uninhabitable and caused extensive damage to the kitchen, bathrooms, and one bedroom of Zimmer's apartment. On February 1, 1990, Young and Zimmer moved out. The resulting loss of income caused a default on both mortgages.

On April 1, 1990, Acme refused to pay the fire loss claiming that the required insurable interest did not exist at the time of the loss and that the amount of the insurance was insufficient to provide full coverage for the loss. Tower and Dodd are involved in a lawsuit contesting the ownership of the building and the claims they have both made for any fire insurance proceeds.

On June 1, 1990, Midway and New foreclosed their mortgages and are also claiming any fire insurance proceeds that may be paid by Acme.

On July 1, 1990, Tower sued Zimmer for breach of the lease and is seeking to collect the balance of the lease term rent.

The above events took place in a notice-race statute jurisdiction.

Required:
Answer the following questions and give the reasons for your conclusions.

a. Who had title to the building on January 21, 1990?

b. Did Tower and/or Dodd have an insurable interest in the building when the fire occurred? If so, when would such an interest have arisen?

c. Does Acme have to pay under the terms of the fire insurance policy? If so, how much?

d. Assuming the fire insurance proceeds will be paid, what would be the order of payment to the various parties and in what amounts?

e. Would Tower succeed in the suit against Zimmer?

C. Fire and Casualty Insurance

N88
Number 2 (Estimated time —— 15 to 20 minutes)

Dunn & Co., CPAs, while performing the 1987 year-end audit of Starr Corp.'s financial statements discovered that certain events during 1987 had resulted in litigation.

Starr had purchased the warehouse on March 1, 1987. The contract between Birk and Starr provided for a closing on September 20, 1987. On July 1, 1987, Birk executed a contract to purchase the warehouse from Starr for $200,000. On September 1, 1987, Birk contacted Starr and demanded that the purchase price be reduced to $190,000 because of a sudden rise in interest rates and declining value of real estate. Starr orally agreed to change the price to $190,000. On September 2, Birk sent Starr a signed memo confirming the reduction in price to $190,000. Starr did not sign the memo or any other agreement reducing the price. On September 15, Starr, by telephone, informed Birk that it would not sell the warehouse for $190,000. Birk refused to pay Starr $200,000 and a closing never occurred.

On October 30, 1987, a fire caused $80,000 damage to the warehouse at a time when its fair market value was $200,000. Starr had obtained a $160,000 fire insurance policy on February 15, 1987, from Pica Casualty Co., covering the warehouse. On April 11, 1987, Starr obtained another fire insurance policy from Drake Insurance Co. covering the warehouse for $40,000. Each policy contained an 80% coinsurance clause and a provision limiting each company's liability to its proportion of all insurance covering the loss. Pica has refused to pay any amount on its policy.

Starr commenced actions against Birk and Pica asserting the following:

- Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of $200,000.

- Starr has an insurable interest in the warehouse covered under the policy with Pica.

- Starr has met the coinsurance requirement under Pica's policy.

- Starr is entitled to recover the entire $80,000 from Pica.

Required: Discuss Starr's assertions, indicating whether such assertions are correct and the reasons therefor.

I. The CPA and the Law

M92
Answer 3 (10 points)

a. The income beneficiaries will win their suit for negligence against Goodwin. Goodwin was negligent in improperly allocating trust income and in paying a beneficiary's creditor. The beneficiaries sustained losses due to Goodwin's failure to exercise the due care required of a reasonable accountant.

b. The income beneficiaries will win their suit for fraud against Goodwin. Goodwin intentionally concealed the embezzlements and made material misstatements in the tax returns. These actions are considered fraud and will permit the beneficiaries, who relied on Goodwin to prepare the returns, to recover their losses.

c. The income beneficiaries will win their suit for breach of fiduciary duty against Goodwin. The following fiduciary duties were breached by Goodwin:

- The fiduciary duty of loyalty by personally benefitting from and concealing the embezzlements.
- The fiduciary duty of obedience by paying the beneficiary's creditor.
- The fiduciary duty of due care by misallocating trust principal and income, paying the creditor, and falsifying tax returns.
- The fiduciary duty to notify by failing to inform the beneficiaries of the embezzlements.
- The fiduciary duty to account by maintaining improper records and profiting from the embezzlements.

M91
Answer 5 (10 points)

a. Knox would recover from Garson for fraud. The elements of fraud are: the misrepresentation of a material fact (because Garson issued an unqualified opinion on misleading financial statements. Garson's opinion did not include adjustments for or disclosures about the embezzlements and insider stock transactions); with knowledge or scienter (because Garson was aware of the embezzlements and insider stock transactions); and a loss sustained by Knox (because of Sleek's default on the loan).

b. 1. The general public purchasers of Sleek's stock offerings would recover from Garson under the liability provisions of Section 11 of the Securities Act of 1933. Section 11 of the Act provides that anyone, such as an accountant, who submits or contributes to a registration statement or allows material misrepresentations or omissions to appear in a registration statement is liable to anyone purchasing the security who sustains a loss. Under the facts presented, Garson could not establish a "due diligence" defense to a Section 11 action because it knew that the registration statement failed to disclose material facts.

b. 2. The general public purchasers of Sleek's stock offerings would also recover from Garson under the antifraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Under Rule 10b-5, Garson's knowledge that the registration statement failed to disclose a material fact, such as the insider trading and the embezzlements, is considered a fraudulent action. The omission was material. Garson's action was intentional or, at a minimum, a result of gross negligence or recklessness (scienter). These purchasers relied on Garson's opinion on the financial statements and incurred a loss.

M90
Answer 3 (10 points)

a. Yes. Since there is no accountant-client privilege recognized at common law and there is no applicable state statute creating such a privilege, Apple will be required to produce its working papers. Furthermore, the right to assert the accountant-client privilege, when applicable, generally rests with the client and not with the accountant.

b. The elements necessary to establish negligence are:

- A legal duty to protect the plaintiff (Musk) from unreasonable risk.
- A failure by the defendant (Apple) to perform or report on an engagement with the due care or competence expected of members of its profession.
- A causal relationship, i.e., that the failure to exercise due care resulted in the plaintiff's loss.
- Actual damage or loss resulting from the failure to exercise due care.

c. The elements necessary to establish a violation of Rule 10b-5 include:

- A material misstatement or omission.
- The material misstatement or omission made by the defendant (Apple) with knowledge (scienter). Reckless disregard for the truth may constitute scienter.
- Justifiable reliance on the misstatement or omission.
- The reliance being in connection with the purchase or sale of a security.

d. Apple is not in privity of contract with Musk because there is no direct contractual relationship between them. Therefore, in the absence of other factors, Apple would not be liable to Musk for Apple's alleged negligence based on the *Ultramares* decision. However, the privity defense would not protect Apple if Musk could prove that Apple had committed actual or constructive fraud (that is, Apple owes a duty to all persons, including third persons, to practice its profession in a non-fraudulent manner).

N89
Answer 3 (10 points)

City is likely to prevail against Salam based on constructive fraud. To establish a cause of action for constructive fraud, City must prove that:

- Salam made a materially false statement of fact.
- Salam lacked a reasonable ground for belief that the statement was true. Constructive fraud may be inferred from evidence of gross negligence or recklessness.
- Salam intended another to rely on the false statement.
- City justifiably relied on the false statement.
- Such reliance resulted in damages or injury.

Under the facts of this case, Salam is likely to be liable to City based on constructive fraud. Salam made a materially false statement of fact by rendering an unqualified opinion on Bell's financial statements. Salam lacked a reasonable ground for belief that the financial statements were fairly presented by recklessly departing from the standards of due care in that it failed to investigate other embezzlements, despite having knowledge of at least one embezzlement, and did not notify Bell's management of the matter. Salam intended that others rely on the audited financial statements. City justifiably relied on the audited financial statements in deciding to loan Astor $600,000 and damages resulted evidenced by Astor's default on the City loan.

City is not likely to prevail against Salam based on negligence. In order to establish a cause of action for negligence against Salam, City must prove that:

- Salam owed a legal duty to protect City.
- Salam breached that legal duty by failing to perform the audit with the due care or competence expected of members of the profession.
- City suffered actual losses or damages.
- Salam's failure to exercise due care proximately caused City to suffer damages.

The facts of this case establish that Salam was negligent by not detecting the overstatement of accounts receivable because of its inadvertent failure to follow its audit program. However, Salam will not be liable to City for negligence because Salam owed no duty to City. This is the case because Salam was not in privity of contract with City, and the financial statements were neither audited by Salam for the primary benefit of City, nor was City within a known and intended class of third party beneficiaries who were to receive the audited financial statements.

N88
Answer 5 (10 points)

Crea will not be liable to the purchasers of the common stock. Although an offering of securities made pursuant to Regulation D is exempt from the registration requirements of the Securities Act of 1933, the antifraud provisions of the federal securities acts continue to apply. In order to establish a cause of action under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934, the purchasers generally must show that: Crea made a material misrepresentation or omission in connection with the purchase or sale of a security; Crea acted with some element of scienter (intentional or willful conduct); Crea's wrongful conduct was material; the purchasers relied on Crea's wrongful conduct; and, that there was a sufficient causal connection between the purchasers' loss and Crea's wrongful conduct.

Under the facts of this case, Crea's inadvertent failure to exercise due care, which resulted in Crea's not detecting the president's embezzlement, will not be sufficient to satisfy the scienter element because such conduct amounts merely to negligence. Therefore, Crea will not be liable for damages under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934.

Crea is likely to be held liable to Safe Bank based on Crea's negligence despite the fact that Safe is not in privity of contract with Crea. In general, a CPA will not be liable for negligence to creditors if its auditor's report was primarily for the benefit of the client, for use in the development of the client's business, and only incidentally or collaterally for the use of those to whom the client might show the financial statements. However, a CPA is generally liable for ordinary negligence to third parties if the audit report is for the identified third party's primary benefit.

In order to establish Crea's negligence, Safe must show that: Crea had a legal duty to protect Safe from unreasonable risk; Crea failed to perform the audit with the due care or competence expected of members of its profession; there was a causal relationship between

Safe's loss and Crea's failure to exercise due care; actual damage or loss resulting from Crea's failure to exercise due care. On the facts of this case, Crea will be liable based on negligence since the audited financial statement reports were for the primary benefit of Safe, an identified third party, and Crea failed to exercise due care in detecting the president's embezzlement, which resulted in Safe's loss, i.e., Dark's default in repaying the loan to Safe.

M88

Answer 5 (10 points)

a. The December 5 oral agreement between Cream and Apple is unenforceable because the agreement failed to comply with the requirements of the statute of frauds. A contract that cannot possibly be performed within one year from the making of the contract falls within the provisions of the statute of frauds. As the facts clearly indicate, the December 5 oral agreement could not possibly be performed within one year of the making of the agreement (December 5, 1987) since the agreement required Apple to continue to perform until December 20, 1988. Therefore, the oral agreement is unenforceable.

b. The agreement between Nestar and Apple restricting Nestar from competing with Apple for three years within the city where Nestar's office and the majority of Nestar's clients were located is likely to be enforceable. An agreement not to compete will be enforceable if there has been a sale of a business including goodwill and the purpose of the restraint is to protect a property interest of the purchaser; the restraint is reasonable as to the geographic area covered; and the restraint is reasonable as to the time period. Under the facts of this case, the agreement not to compete is likely to be enforceable. The transaction involves the sale of Nestar's management consulting business and goodwill. The purpose of the restraint is to protect the goodwill. The three year time period is reasonable. The limitation on the geographic area covered by the restraint to only the city where Nestar's office and the majority of Nestar's clients are located appears to be reasonable.

c. Birk will prevail in its action against Kaye based on negligence. Kaye owed a duty to Birk to conduct the audit with due care. Kaye failed to conduct the audit with due care by issuing an unqualified opinion on Apple's 1987 financial statements when, in fact, Apple had made a material error by reporting all of the revenues related to the unenforceable December 5 agreement on its 1987 financial statements. Kaye's issuance of an unqualified opinion despite the material error caused Birk to suffer damages as evidenced by the drastic decrease in the market value of Apple stock.

II. Business Organizations

A. Agency

N90

Answer 3 (10 points)

a. Peterson was acting for an undisclosed principal (Prime) with regard to the contract with Hallow. Peterson was acting with actual authority; therefore, Prime is liable to Hallow. Peterson is also liable to Hallow because agents acting on behalf of undisclosed principals are liable to the third parties on the contracts they enter into with such third parties on behalf of the principal. Hallow, however, cannot collect damages from both Peterson and Prime and must make an election between them.

b. At the time of the accident, Peterson was acting within the scope of employment because the conduct engaged in (that is, entering into a contract with Hallow) was authorized by Prime. Prime, therefore, will be liable to Mathews because the accident occurred within the scope of Peterson's employment.

Peterson will also be liable to Mathews because all persons are liable for their own negligence.

c. Peterson's actual authority to enter into contracts on Prime's behalf ceased on termination of employment by Prime. Peterson, however, continued to have apparent authority to bind Prime because:

- Peterson was acting ostensibly within the scope of authority as evidenced by past transactions with Bagley;
- Bagley was unaware of Peterson's termination.

The trade journal announcement was not effective notice to terminate Peterson's apparent authority in relation to Bagley because:

- Prime was obligated to give actual notice to Bagley that Peterson was no longer employed;
- Actual notice is required because of Bagley's past contact with Peterson while Peterson was employed by Prime.

B. Partnerships and Joint Ventures

M91
Answer 2 (10 points)

a. 1. Mathews' first position is incorrect. A partner is considered an agent of the partnership in carrying out its usual business. In this case, Baker lacked actual authority to bind Prime to the Jaco contract; however, Baker did have, from Jaco's perspective, apparent authority to do so because of the general character of Prime's business and, more important, because Baker had previously purchased cars from Jaco on Prime's behalf. Jaco was not bound by the limitation on Baker's authority unless Jaco was aware of it.

2. Mathews' second position is also incorrect. As a general rule, a partner is liable for the debts of the partnership, and a third party is not bound by the profit and loss sharing agreements between partners because the third party is not a party to the partnership agreement. Therefore, Jaco can look to Prime's assets and Mathews' personal assets to satisfy the obligation.

3. Mathews' third position is correct. A partner is liable to other partners for any liability associated with contracts entered into ostensibly on behalf of the partnership but outside the partner's actual authority. In this case, because Baker violated the agreement with Mathews concerning the $15,000 limitation on used car purchases, Baker will be liable to Mathews for any liability that Mathews may have to Jaco.

4. Mathews' fourth position is also correct. A partner owes a fiduciary duty (that is, a duty of loyalty) to the partnership and every other partner. A partner may not benefit directly or indirectly at the expense of the partnership. A partner must account to the partnership for any benefits derived from the partnership's business without the consent or knowledge of the other partners. In this case, Baker was not entitled to accept and retain the incentive payments made by Top. Doing so violated Baker's fiduciary duty to Prime and Mathews. Baker must account to Prime for all the incentive payments received.

b. KYA's contention that its $25,000 capital contribution cannot be used to satisfy Prime's obligation to Jaco is incorrect. A new partner is liable for partnership liabilities that arose prior to the new partner's admission, but the liability is limited to the partner's capital contribution and interest in partnership property. Therefore, KYA's liability is limited to its capital contribution and its interest as a partner in Prime's assets.

M90
Answer 4 (10 points)

a. Weil is entitled to inspect and copy Sterling's books and records. A limited partner such as Weil has the right to have the partnership books kept at the principal place of business of the partnership and to inspect and copy them at all times.

b. Generally, limited partners are not liable to partnership creditors except to the extent of their capital contribution. In Weil's case, however, he will probably be liable to Anchor Bank in the same manner as Sterling's general partners because he has taken part in the control of the business of the partnership and, therefore, has lost his limited liability. Smith, as a general partner, would also be personally liable to Anchor because liability was incurred prior to withdrawal.

c. Edwards will likely prevail in his lawsuit against Smith for withdrawing because the partnership agreement specifically prohibits a withdrawal by a general partner without the consent of the other partners. Therefore, Smith has breached the partnership agreement and will be liable to Edwards for any damages resulting from Smith's withdrawal.

d. The withdrawal (retirement) of a general partner dissolves the partnership unless the remaining general partners continue the business of the partnership under a right to do so provided in the limited partnership certificate, or unless all partners consent. Therefore, it is possible that Smith's withdrawal will result in Sterling's dissolution.

e. Weil is free to assign his limited partnership interests to Alberts in the absence of any prohibitions in the Sterling partnership agreement or certificate.

f. Alberts, however, cannot be a substitute limited partner without the consent of the remaining general partner, Edwards.

g. Therefore, Alberts, as an assignee of Weil's limited partnership interest, may not exercise any rights of a partner. Alberts is entitled only to any distributions from Sterling to which Weil would have been entitled.

h. Finally, the assignment by Weil of his partnership interest does not cause a dissolution of the partnership.

N88
Answer 4 (10 points)

a.1. The partnership cannot recover the ½% commission from King because Rey had the apparent authority to reduce the commission to 1½%. The Uniform Partnership Act states that every partner is an agent of the partnership for the purpose of its business, and the act of every partner for apparently carrying on in the usual way the business of the partnership, binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom the partner is dealing has knowledge of the fact that the partner has no such authority. In determining whether Rey had the apparent authority to bind the partnership, one must examine the circumstances and conduct of the parties and whether King reasonably believed such authority to exist. Because brokerage commissions are generally not uniform, it would be reasonable for King to believe that Rey had the authority to perform the transaction at 1½% commission. Furthermore, King lacked knowledge of the restriction in the partnership agreement that prohibited Rey from reducing a commission below 2% without the other partners' consent. Therefore, King will not be liable for the ½% commission.

a.2. The partnership can recover the ½% commission from Rey because Rey violated the partnership agreement by reducing the commission to 1½% without the partners' consent. Rey owes a duty to act in accordance with the partnership agreement.

b.1. Under the Uniform Partnership Act, a person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before being admitted as though that person had been a partner when such obligations were incurred, except that this liability may be satisfied only out of partnership property. Thus, Park will not be personally liable for the partnership obligations arising prior to being admitted as a partner but would be liable based upon the extent of partnership interests held. Park will be personally liable for partnership obligations arising after being admitted to the partnership.

b.2. Stein will continue to be personally liable for partnership obligations arising prior to withdrawing from the partnership, unless Stein obtains a release from the existing creditors. Stein will have no liability for partnership obligations arising after actual and constructive notice of withdrawing was properly given. However, Stein may be personally liable for partnership obligations arising after withdrawing but prior to notice being given. Actual notice of Stein's withdrawal was given by written notification to partnership creditors that had conducted business with the partnership prior to May 15. Constructive notice of Stein's withdrawal was given by proper publication in two newspapers to those third parties who had not dealt with the partnership, but may have known of its existence.

M88

Answer 3 (10 points)

A limited partnership is formed by two or more persons under a state's limited partnership statute, having as members one or more general partners and one or more limited partners. Two or more persons desiring to form a limited partnership must execute a certificate of limited partnership that must be filed in the office of the secretary of state, or other appropriate state or local office. A corporation may be formed only under a state incorporation statute that requires that one or more incorporators sign articles of incorporation which must be filed with the secretary of state.

Unless otherwise provided in the partnership agreement, or other agreements among the partners, a limited partnership interest is assignable in whole or in part. Similarly, in the absence of a restriction in the corporation's organizational documents or other agreements among the shareholders, shares of stock are freely transferable.

A limited partner's liability for partnership debts is generally limited to the partner's investment (capital contribution) in the partnership if the interest is fully paid and non-assessable and the partner does not participate in the daily management of the business. Likewise, a shareholder's liability for a corporation's debts is generally limited to the shareholder's investment (capital contribution) in the corporation.

A limited partner cannot participate in the daily operations of the partnership's business without losing limited liability. A shareholder who is not also an officer or a director cannot participate in the daily operations of the corporation's business. However, a shareholder owning voting stock has the right to vote for a board of directors, which will manage the business affairs of the corporation. The board of directors elects officers to run the daily operations of the corporation.

A limited partner is entitled to receive a share of the partnership's profits in the manner provided in the partnership agreement. On the other hand, whether a shareholder receives dividends is generally within the discretion of the board of directors.

C. Corporations

N91

Answer 2 (10 points)

Bradley would be successful in the suit against Frost and Glen for failing to vote Bradley to the board of directors. The stockholders have the right to elect the directors of a corporation. The stockholders have the right to agree among themselves on how they will vote. Therefore, the voting provision of the stockholders' agreement between Bradley, Frost, and Glen is enforceable.

Bradley would be unsuccessful in attempting to be reinstated as vice president. A corporation's board oversees the operations of the business, which includes hiring officers and, at its discretion, dismissing officers with or without cause. Bradley would be successful in collecting some damages for the breach of the employment contract because there was no demonstrated cause for Bradley's dismissal.

Bradley would be successful in having Frost and Glen held personally liable to the corporation for declaring and paying the dividend because payment of a dividend that threatens a corporation's solvency is unlawful. Ordinarily, directors who approve such a dividend would be personally liable for its repayment to the corporation. However, the directors, other than Frost and Glen, in relying on the assurances and information supplied by Frost and Glen, as corporate officers, are protected by the business judgment rule. Therefore, only Frost and Glen would be held personally liable.

N89
Answer 5 (10 points)

West's assertion that Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability is incorrect. A shareholder of cumulative preferred stock is entitled to receive all dividend arrearages plus any dividends for the current year before any dividends may be distributed to the shareholders of common stock. However, preferred stock represents a contribution of capital, not a debt of the corporation, and until a dividend is declared, a shareholder of cumulative preferred stock is not a creditor of the corporation. Thus, Ace was correct in not classifying the dividend arrearages as a liability because a dividend was not declared by Ace's board of directors. Ace should disclose the dividend arrearages in notes to its financial statements.

West's assertion that West is entitled to examine Ace's books and records is correct. A shareholder, upon written demand, is entitled to examine, at reasonable times, the books and records of the corporation, so long as the examination is for a proper purpose (in good faith). If the corporation refuses to permit the examination, the shareholder may obtain a court order compelling access to the books and records.

West's assertion that West is entitled to receive a new stock certificate to replace the lost stock certificate is correct. Because the subject matter in this case is a stock certificate of a corporation, the UCC Investment Securities Article applies. Under that article, the stock certificate of Ace is classified as a certificated security because it is one of a class of Ace's shares that is represented by an instrument in West's name and is traded on a national securities exchange. If the owner of a certificated security claims that the security has been lost, the issuer shall issue a new certificated security, or, at the option of the issuer, an equivalent uncertificated security in place of the original security if the owner makes a request before the issuer has notice that the security has been acquired by a bona fide purchaser; files a sufficient indemnity bond with the issuer; and satisfies any other reasonable requirements imposed by the issuer. Based on the facts of this case, West is entitled to receive a new stock certificate because West requested that a new stock certificate be issued before Ace had notice the lost certificate was acquired by any other party; offered to file an indemnity bond with Ace; and offered to cooperate with any reasonable requests made by Ace.

M89
Answer 4 (10 points)

The assertion that it was improper for the board of directors to authorize the reacquisition of Cray's common stock while Cray was insolvent is correct. A board of directors may authorize and the corporation may reacquire its shares of stock subject to any restriction in the articles of incorporation, except that no reacquisition may be made if, after giving effect thereto, either the corporation would be unable to pay its debts as they become due in the usual course of business or the corporation's total assets would be less than its total liabilities. Because Cray was insolvent before and after the reacquisition of Cray's common stock, it was improper for the board of directors to authorize the reacquisition.

The assertion that the members of Cray's board of directors are personally liable because Cray reacquired its own shares of Cray stock while Cray was insolvent is incorrect. In general, directors who vote or assent to a reacquisition by the corporation of its own shares while the corporation is insolvent will be jointly and severally liable to the corporation. However, the directors will not be liable if they acted in good faith, in a manner they reasonably believed to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing their duties, directors are entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data prepared or presented by one or more officers or employees of the corporation whom the directors reasonably believe to be reliable and competent in the matters presented. The directors may rely on the same information prepared or presented by independent accountants that the directors reasonably believe to be within such person's professional competence. Based on the facts of this case, the directors' reliance on the reports and financial statements prepared by Cray's internal accounting department under the supervision of the treasurer and reviewed by its independent accountants was proper so long as the directors exercised due care, acted in good faith, and acted without knowledge that would cause such reliance to be unwarranted. In addition, the courts are precluded from substituting their business judgment for that of the board of directors if the directors have acted with due care and in good faith.

The assertion that Cray will be liable to the treasurer as a result of his termination by the board of directors is correct. An officer may be removed by the board of directors with or without cause whenever in its judgment the best interests of the corporation will be served by the removal. However, such removal is without prejudice to the contract rights of the person so removed. Thus, the board of directors had the power to remove the treasurer. The treasurer will prevail in a breach of contract action for damages against Cray because the firing violated the employment agreement.

N88
Answer 3 (10 points)

Dodd is entitled to recover workers' compensation benefits from Spear because Dodd was an employee of Salam, the injury was accidental, and the injury occurred out of and in the course of his employment with Salam. Based on the facts of this case, Dodd would be considered an employee and not an independent contractor because Salam had control over the details of Dodd's work by training Dodd to perform the services in a specified manner and Dodd was subject to Salam's supervision.

Dodd will be unsuccessful in his action against Salam based on negligence in training him because Dodd is an employee of Salam and Salam has complied with the applicable compulsory workers' compensation statute by obtaining workers' compensation insurance. Under workers' compensation, an employee who receives workers' compensation benefits cannot successfully maintain an action for negligence against his employer seeking additional compensation. Therefore, whether Salam was negligent in training Dodd is irrelevant.

Dodd's action against Ace based on strict liability in tort will be successful. Generally, in order to establish a cause of action based on strict liability in tort, it must be shown that: the product was in defective condition when it left the possession or control of the seller; the product was unreasonably dangerous to the consumer or user; the cause of the consumer's or user's injury was the defect; the seller engaged in the business of selling such a product; the product was one which the seller expected to, and, did reach the consumer or user without substantial changes in the condition in which it was sold. Under the facts of this case, Ace will be liable based on strict liability in tort because all of the elements necessary to state such a cause of action have been met. The fact that Dodd is entitled to workers' compensation benefits does not preclude Dodd from recovering based on strict liability in tort from a third party (Ace).

Maple will not be liable to the restaurant patrons based on negligence, because shareholders of a corporation are insulated from personal liability for the negligence of the corporation or the corporation's employees. This rule would apply even though Maple owned a controlling interest in the common stock of Salam. Therefore, whether Salam or Dodd was negligent is irrelevant.

M88
Answer 3 (10 points)

A limited partnership is formed by two or more persons under a state's limited partnership statute, having as members one or more general partners and one or more limited partners. Two or more persons desiring to form a limited partnership must execute a certificate of limited partnership that must be filed in the office of the secretary of state, or other appropriate state or local office. A corporation may be formed only under a state incorporation statute that requires that one or more incorporators sign articles of incorporation which must be filed with the secretary of state.

Unless otherwise provided in the partnership agreement, or other agreements among the partners, a limited partnership interest is assignable in whole or in part. Similarly, in the absence of a restriction in the corporation's organizational documents or other agreements among the shareholders, shares of stock are freely transferable.

A limited partner's liability for partnership debts is generally limited to the partner's investment (capital contribution) in the partnership if the interest is fully paid and non-assessable and the partner does not participate in the daily management of the business. Likewise, a shareholder's liability for a corporation's debts is generally limited to the shareholder's investment (capital contribution) in the corporation.

A limited partner cannot participate in the daily operations of the partnership's business without losing limited liability. A shareholder who is not also an officer or a director cannot participate in the daily operations of the corporation's business. However, a shareholder owning voting stock has the right to vote for a board of directors, which will manage the business affairs of the corporation. The board of directors elects officers to run the daily operations of the corporation.

A limited partner is entitled to receive a share of the partnership's profits in the manner provided in the partnership agreement. On the other hand, whether a shareholder receives dividends is generally within the discretion of the board of directors.

D. Estates and Trusts

M92
Answer 3 (10 points)

a. The income beneficiaries will win their suit for negligence against Goodwin. Goodwin was negligent in improperly allocating trust income and in paying a beneficiary's creditor. The beneficiaries sustained losses due to Goodwin's failure to exercise the due care required of a reasonable accountant.

b. The income beneficiaries will win their suit for fraud against Goodwin. Goodwin intentionally concealed the embezzlements and made material misstatements in the tax returns. These actions are considered fraud and will permit the beneficiaries, who relied on Goodwin to prepare the returns, to recover their losses.

c. The income beneficiaries will win their suit for breach of fiduciary duty against Goodwin. The following fiduciary duties were breached by Goodwin:

- The fiduciary duty of loyalty by personally benefitting from and concealing the embezzlements.
- The fiduciary duty of obedience by paying the beneficiary's creditor.
- The fiduciary duty of due care by misallocating trust principal and income, paying the creditor, and falsifying tax returns.
- The fiduciary duty to notify by failing to inform the beneficiaries of the embezzlements.
- The fiduciary duty to account by maintaining improper records and profiting from the embezzlements.

N89
Answer 2 (10 points)

a. Sam Bean and Bob Bean will not be personally liable to Fale for the deficiency resulting from the foreclosure sale because they did not assume the mortgage but instead purchased the building subject to the mortgage. In the absence of a state statute to the contrary, Stein will be personally liable for the deficiency because Stein was not released from liability on the note and mortgage.

b. There is no right of survivorship feature in a tenancy in common and, therefore, Rita Bean will acquire Sam Bean's one-half interest in the building under her husband's will. Thus, Rita Bean will own a one-half interest in the building as a tenant in common with Bob Bean.

c. In general, the purposes and benefits of creating a spendthrift trust are to provide a fund for the maintenance of another (the beneficiary); protect the fund from the beneficiary's financial mismanagement and improvidence; prohibit the beneficiary from transferring the right to future trust income or principal; and prohibit the beneficiary's interest from being subjected to the claims of the beneficiary's creditors.

d.1. A trust may generally be terminated by the beneficiaries if all consent to the termination; all are legally competent to consent; and termination will not defeat a material purpose for which the trust was created.

2. The spendthrift trust created by Sam Bean cannot be terminated by Bob Bean because the major purpose of a spendthrift trust is to protect the beneficiary from mismanagement and improvidence. Thus, termination of the spendthrift trust would defeat the purpose for which it was created.

III. Contracts

N91
Answer 3 (10 points)

Stake's first allegation, that Packer committed fraud in the formation of the contract, is correct and Stake may rescind the contract. Packer had assured Stake that the vacant parcel would be used for a shopping center when, in fact, Packer intended to use the land to construct apartment units that would be in direct competition with those owned by Stake. Stake would not have sold the land to Packer had Packer's real intentions been known. Therefore, the elements of fraud are present:

- A false representation;
- Of a fact;
- That is material;
- Made with knowledge of its falsity and intention to deceive;
- That is justifiably relied on.

Stake's second allegation, that the mistake as to the fair market value of the land entitles Stake to rescind the contract, is incorrect. Generally, mistakes as to adequacy of consideration or fairness of a bargain are insufficient grounds to entitle the aggrieved party to rescind a contract.

Stake's third allegation, that the contract was not enforceable against Stake because Stake did not sign the counteroffer, is correct. The contract between Stake and Packer involves real estate and, therefore, the Statute of Frauds requirements must be satisfied. The Statute of Frauds requires that a writing be signed by the party against whom enforcement is sought. The counteroffer is unenforceable against Stake, because Stake did not sign it. As a result, Stake is not obligated to sell the land to Packer under the terms of the counteroffer.

N90
Answer 2 (10 points)

Snow's assertion that Jacobs' acceptance was not received on a timely basis is incorrect. Jacobs' January 31 acceptance was effective when dispatched (mailed) under the complete-when-posted doctrine because:

- The letter was an authorized means of communication (because Snow's offer was by mail); and
- The letter was properly stamped and addressed.

Therefore, Jacobs' acceptance was effective on January 31, the last possible day under Snow's January 21 offer.

Snow's assertion that the January 21 offer was effectively revoked is incorrect because a revocation is not effective until received. In this case, the revocation was effective on February 3, and Jacobs' acceptance was effective on January 31.

Snow's assertion that Jacobs' failure to sign the January 31 acceptance prevents the formation of a contract is incorrect. The Statute of Frauds, which applies to contracts involving interests in real estate, requires only the signature of the party to be charged with enforcement of the contract. Therefore, because Snow had signed the January 21 offer, which was accepted by Jacobs, the contract is enforceable against Snow.

Snow's assertion that Jacobs had no right to assign the contract is incorrect. Contract rights, including the right to purchase real estate, are generally assignable unless the assignment:

- Would materially increase the risk or burden of the obligor;
- Purports to transfer highly personal contract rights;
- Is validly prohibited by the contract; or
- Is prohibited by law.

None of these limitations applies to the assignment by Jacobs to Eljay.

N89
Answer 4 (10 points)

The president's assertion that the September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and that, therefore, a contract was formed by Anker's acceptance on December 12, 1988, is incorrect. Because the offer made by Crisp involves a transaction in goods, i.e. furniture, the UCC Sales Article applies. The UCC Sales Article provides that an offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or, if no time is stated, for a reasonable time, but in no event may such period of irrevocability exceed three months. Under the facts of this case, Crisp's offer was a firm offer that could not be revoked because the offer was made by Crisp, a merchant, concerning the kind of goods being sold (furniture); was in writing and signed by Crisp; and stated that it would remain open until December 20, 1988. Despite the provision that the offer will remain open until December 20, 1988, a firm offer remains irrevocable for a three-month period. Therefore, Crisp's letter of revocation on December 5, 1988 did not terminate the firm offer because the three-month period had not yet expired. The revocation was effective on December 8, 1988, when the three-month period expired. Therefore, Anker's attempted acceptance on December 12, 1988 did not form a contract with Crisp. Instead, Anker's attempted acceptance is likely to be treated as an offer.

The president's assertion that Dix's December 12, 1988 letter formed an option contract is incorrect. To form an option contract, where the subject matter is real estate, all of the elements necessary to form a contract must be met. In this case, Anker did not furnish any consideration in return for Dix's promise to keep the offer open until December 20, 1988; therefore, an option contract was not formed.

The president's assertion that Anker's acceptance on December 19, 1988 formed a contract with Dix is incorrect. In general, acceptance of an offer is effective when it is dispatched. If, however, an offer specifically stipulates the method of communication to be utilized by the offeree, the acceptance to be effective must conform to that method. Thus, an acceptance by another method of communication is ineffective and no contract is formed. Under the facts of this case, Anker's acceptance on December 19, 1988 by a private express mail courier is ineffective, despite Dix's receipt of the acceptance on December 20, 1988, because Dix's offer specifically stipulated that acceptance could only be made by certified mail, return receipt requested. Instead, Anker's attempted acceptance is likely to be treated as a counteroffer.

N88
Answer 2 (10 points)

Starr's first assertion, that Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of $200,000, is correct. An oral agreement modifying an enforceable existing contract is not enforceable if the modification is within the statute of frauds. A contract for the sale of real estate or a modification of such a contract falls within the provisions of the statute of frauds and therefore a writing signed by the party to be charged is required. The fact that Birk sent a signed memo to Starr is not effective because it was not signed by Starr. Furthermore, the agreement to reduce the purchase price to $190,000 is not enforceable because Birk did not give any consideration for the modification. Birk had a pre-existing obligation to purchase the warehouse for $200,000 and gave no new consideration for the modification of the price. The fact that Birk may have acted in good faith as a result of the decline in value of real estate and rise in interest rates will not be sufficient to make the oral agreement enforceable against Starr. Therefore, Birk's failure to pay $200,000 as required by the July 1 contract constitutes a breach of that contract.

Starr's second assertion, that it has an insurable interest in the warehouse covered by the Pica policy, is correct. To constitute an insurable interest the element of financial or economic loss to the insured must be present. Furthermore, the insurable interest must be present at the time of the loss but need not be present at the time the policy was issued. Under the facts of this case, Starr had an insurable interest on the date of the loss (October 30) since it owned the warehouse on that date. Whether Starr had an insurable interest on February 15 will not affect Starr's right to recover from Pica.

Starr's third assertion, that it has met the coinsurance requirement under Pica's policy is correct.

Starr's fourth assertion, that Starr is entitled to recover the entire $80,000 from Pica is incorrect. Starr recover the entire $80,000 from Pica is incorrect. Starr is only entitled to receive $64,000 from Pica calculated as follows:

$$\frac{\text{\$160,000 (Amount of Insurance Coverage with Pica)}}{\text{\$200,000 (Total Amount of Insurance on Warehouse)}} \times \text{\$80,000 (Amount to be Paid)} = \text{\$64,000}$$

Thus, Pica's liability is limited to the amount its policy bears to the total amount of insurance on the warehouse.

M88
Answer 5 (10 points)

a. The December 5 oral agreement between Cream and Apple is unenforceable because the agreement failed to comply with the requirements of the statute of frauds. A contract that cannot possibly be performed within one year from the making of the contract falls within the provisions of the statute of frauds. As the facts clearly indicate, the December 5 oral agreement could not possibly be performed within one year of the making of the agreement (December 5, 1987) since the agreement required Apple to continue to perform until December 20, 1988. Therefore, the oral agreement is unenforceable.

b. The agreement between Nestar and Apple restricting Nestar from competing with Apple for three years within the city where Nestar's office and the majority of Nestar's clients were located is likely to be enforceable. An agreement not to compete will be enforceable if there has been a sale of a business including goodwill and the purpose of the restraint is to protect a property interest of the purchaser; the restraint is reasonable as to the geographic area covered; and the restraint is reasonable as to the time period. Under the facts of this case, the agreement not to compete is likely to be enforceable. The transaction involves the sale of Nestar's management consulting business and goodwill. The purpose of the restraint is to protect the goodwill. The three year time period is reasonable. The limitation on the geographic area covered by the restraint to only the city where Nestar's office and the majority of Nestar's clients are located appears to be reasonable.

c. Birk will prevail in its action against Kaye based on negligence. Kaye owed a duty to Birk to conduct the audit with due care. Kaye failed to conduct the audit with due care by issuing an unqualified opinion on Apple's 1987 financial statements when, in fact, Apple had made a material error by reporting all of the revenues related to the unenforceable December 5 agreement on its 1987 financial statements. Kaye's issuance of an unqualified opinion despite the material error caused Birk to suffer damages as evidenced by the drastic decrease in the market value of Apple stock.

IV. Debtor-Creditor Relationships

B. Bankruptcy

M92
Answer 4 (10 points)

a. An involuntary bankruptcy petition may be filed against a debtor having 12 or more creditors by at least three creditors having unsecured claims of at least $5,000, provided the debtor is not paying its undisputed debts as they become due.

b. 1. Dollar's motion for relief will be granted. Dollar's claim that it is entitled to take possession of the collateral securing its loan is correct. Generally, a secured creditor is allowed to take possession of its collateral if there is no equity in it (that is, the debt balance exceeds the collateral's fair market value). Dollar would then be entitled to sell the collateral and apply the proceeds to the loan balance.

2. Dollar's claim that it is entitled to a priority distribution to the extent that the proceeds from the sale of its collateral are less than the loan balance will not be approved by the bankruptcy court. Dollar is entitled to the value of its collateral. As to any deficiency, Dollar will be treated as an unsecured creditor.

c. The payment to Techno's president would be regarded as a preferential transfer. Because the president is an "insider," any payments made on the unsecured loan during the year preceding the bankruptcy filing would be considered a preferential transfer.

The payment to Alexis was not a preferential transfer because it was made in the ordinary course of business and under ordinary business terms.

The $7,900 payment to Maple for the truck was not a preferential transfer because it was not made on account of an antecedent debt, but as a contemporaneous exchange for new value.

M90
Answer 2 (10 points)

a. The judgment against Drake arising from his negligence is dischargeable in his bankruptcy.

The unpaid federal income taxes are also dischargeable because they became due and owing more than three years prior to the filing of the bankruptcy petition.

The obligation to Bartin will not be discharged because the debt was not included in Drake's bankruptcy petition schedules and the creditor did not have notice or actual knowledge of the bankruptcy in time to file a proof of claim.

The unpaid child support is not dischargeable in Drake's bankruptcy.

b. To establish a preferential transfer that can be set aside, the bankruptcy trustee must show

- A voluntary or involuntary transfer of nonexempt property to a creditor.
- The transfer was made during the ninety days immediately preceding the bankruptcy filing (or within one year in the case of an "insider").
- The transfer was on account of an antecedent debt.
- The transfer was made while the debtor was insolvent.
- The transfer allows the creditor to receive a greater percentage than would otherwise be received in the bankruptcy proceeding.

c. The payment to Safe will be regarded as a preference and may be set aside by the trustee.

The transfer by Drake to his brother can be set aside as a preference since his brother would be considered an insider and payment was made within one year of filing.

Giving the mortgage to Home is not a preference because it was not on account of an antecedent debt.

The payment to Max is not a preference because it was made in the ordinary course of the business of Max and Drake under ordinary business terms.

M89

Answer 2 (10 points)

a. The requirements necessary for the commencement of an involuntary bankruptcy proceeding were met because the petition was filed by Lux, Squire, and Rusk, who were creditors of Tine with unsecured claims aggregating more than $5,000. To properly commence an involuntary bankruptcy proceeding in which the debtor has 12 or more creditors with unsecured claims, three or more creditors with unsecured claims aggregating at least $5,000 must sign the bankruptcy petition.

b. 1. The court may declare the January 31, 1989, mortgage delivered to Safe by Tine to be void as a preference. A preference occurs if there is a transfer of the interest in property:

- To or for the benefit of a creditor;
- For or on account of an antecedent debt owed by the debtor before such transfer was made;
- Made while the debtor was insolvent;
- Made within 90 days before the date of the filing of the bankruptcy petition (when the creditor is not an insider);
- That enables the creditor to receive more than the creditor would receive in a liquidation proceeding.

Under the facts of this case, the mortgage delivered by Tine to Safe was for Safe's benefit, on account of the $250,000 owed to Safe, given while Tine was unable to pay his current obligations (was insolvent), given on January 31, 1989 (which was within 90 days before the filing of the bankruptcy petition on March 23, 1989), and enabled Safe to receive more than it would have received in a liquidation proceeding ($250,000 as a secured creditor vs. a lesser amount as an unsecured creditor in liquidation).

2. The court can except Tine's debt to Rich Bank from Tine's discharge in bankruptcy. In general, the bankruptcy court will except a debt from discharge if the debtor obtains money by use of a statement in writing respecting the debtor's financial condition that is materially false; the creditor to whom the debtor is liable for such money reasonably relied on the statement, and the debtor caused the statement to be made or published with intent to deceive.

Based on the facts of this case, Tine obtained a $50,000 loan after furnishing Rich with personal financial statements, that he knew substantially overstated his net worth. Because it was difficult to detect the overstatement, Rich's reliance on the financial statements was reasonable. Therefore, the requirements necessary to except Rich's debt from Tine's discharge have been met.

V. Government Regulation of Business

A. Regulation of Employment

N88
Answer 3 (10 points)

Dodd is entitled to recover workers' compensation benefits from Spear because Dodd was an employee of Salam, the injury was accidental, and the injury occurred out of and in the course of his employment with Salam. Based on the facts of this case, Dodd would be considered an employee and not an independent contractor because Salam had control over the details of Dodd's work by training Dodd to perform the services in a specified manner and Dodd was subject to Salam's supervision.

Dodd will be unsuccessful in his action against Salam based on negligence in training him because Dodd is an employee of Salam and Salam has complied with the applicable compulsory workers' compensation statute by obtaining workers' compensation insurance. Under workers' compensation, an employee who receives workers' compensation benefits cannot successfully maintain an action for negligence against his employer seeking additional compensation. Therefore, whether Salam was negligent in training Dodd is irrelevant.

Dodd's action against Ace based on strict liability in tort will be successful. Generally, in order to establish a cause of action based on strict liability in tort, it must be shown that: the product was in defective condition when it left the possession or control of the seller; the product was unreasonably dangerous to the consumer or user; the cause of the consumer's or user's injury was the defect; the seller engaged in the business of selling such a product; the product was one which the seller expected to, and, did reach the consumer or user without substantial changes in the condition in which it was sold. Under the facts of this case, Ace will be liable based on strict liability in tort because all of the elements necessary to state such a cause of action have been met. The fact that Dodd is entitled to workers' compensation benefits does not preclude Dodd from recovering based on strict liability in tort from a third party (Ace).

Maple will not be liable to the restaurant patrons based on negligence, because shareholders of a corporation are insulated from personal liability for the negligence of the corporation or the corporation's employees. This rule would apply even though Maple owned a controlling interest in the common stock of Salam. Therefore, whether Salam or Dodd was negligent is irrelevant.

VI. Uniform Commercial Code

A. Commercial Paper

M92
Answer 5 (10 points)

Rustic's first claim, that its security interest is superior to National's, is incorrect. Rustic's security interest was perfected at the time it filed its financing statement, February 9, 1992, because it was a purchase money security interest in inventory. National filed its financing statement on February 7, 1992, therefore, National's security interest was perfected before, and is superior to, Rustic's security interest.

Rustic's second claim, that Karry purchased the lathe subject to Rustic's security interest, is incorrect. Karry, as a buyer in the ordinary course of Friendly's business, purchased the lathe free of any security interest given by Friendly. The fact that Karry was aware of Rustic's security interest does not affect this conclusion.

Karry's first claim, that the note is nonnegotiable, is incorrect. For a promissory note to be negotiable, it must be payable on demand or at a definite time. An instrument is payable on demand when it states that it is so payable, or when it provides no specific time for payment. Therefore, the note would be considered payable on demand.

Also, Karry's promissory note is negotiable despite the reference to the sales invoice because the reference does not make the note subject to the sales contract; rather, the reference only notes the existence of the invoice.

Karry's second claim, that Abcor has no rights to Karry's note because Friendly did not endorse it, is incorrect. The note is a bearer instrument because it is made payable to Friendly or bearer. Bearer instruments may be negotiated by delivery of the instrument alone.

Karry's third claim, that Abcor took the note subject to Karry's dispute with Friendly, is incorrect. Karry's dispute with Friendly was a personal defense to Karry. Even though Abcor took the note knowing of Karry's dispute and, therefore, could not ordinarily be a holder in due course, Abcor did take the note from Queen, which was a holder in due course. Under the "shelter provision" of the UCC Commercial Paper Article, Abcor has the rights of a holder in due course even though it does not qualify as one. As a result, Abcor did not take the note subject to Karry's personal defense, despite knowing of Karry's claim.

M91
Answer 3 (10 points)

Hillcraft's first assertion, that the note is nonnegotiable because it references the license agreement and is not payable at a definite time or on demand, is incorrect. The note is negotiable despite the reference to the license agreement because it does not make the note subject to the terms of the agreement; rather, the reference is regarded only as a recital of its existence.

Also, Hillcraft's right to extend the time for payment does not make the note nonnegotiable because the extension period is for a definite period of time.

Hillcraft's second assertion, that River Oaks is not a holder in due course (HDC) because it received the note as security for an existing debt and, therefore, did not give value for it, is incorrect. Under the UCC Commercial Paper Article, a holder does give value for an instrument when it is taken in payment of, or as security for, an antecedent claim.

Hillcraft's third assertion, that River Oaks is not an HDC because River Oaks was aware of Alexco's alleged breach of the license agreement, is correct. If a holder of a note is aware of a dispute when it acquires the note, that holder cannot be an HDC because it took with notice.

Hillcraft's fourth assertion, that it can raise the alleged breach by Alexco as a defense to payment of the note, is incorrect. Even though River Oaks is not an HDC under the UCC "shelter provision," it is entitled to the protection of an HDC because it took the instrument from First Auto, which was an HDC. Therefore, River Oaks did not take the note subject to Hillcraft's defense based on the alleged breach by Alexco. Hillcraft's defense is considered a personal defense and can only be used by Hillcraft against Alexco.

Hillcraft's fifth assertion, that River Oaks has no right to the note because it was not endorsed by Alexco, is incorrect. River Oaks acquired rights to the Hillcraft note without Alexco's endorsement because the note was a bearer instrument as a result of it being payable to "Alexco Company or bearer." A bearer instrument can be negotiated by delivery alone.

Hillcraft's final assertion, that the maximum amount Hillcraft would owe under the note is $4,000, plus accrued interest, is correct. If there is a conflict between a number written in numerals and also described by words, the words take precedence. Therefore, Hillcraft's maximum potential principal liability is $4,000 under the note.

M90
Answer 5 (10 points)

a. University is not a holder in due course (HDC) with regard to Peters' note. To be an HDC, University must:

- Be a holder of a negotiable instrument.
- Take it for value.
- Take it in good faith.
- Take it without notice that it is overdue or has been dishonored.
- Take it without notice of any defense or claim to it.

All of the above requirements are met except the first. Peters' note is not negotiable because it is not made payable to bearer or to the order of a named payee.

b. University is an assignee of Harris' rights under Peters' note. Therefore, University "stands in the shoes" of Harris, and Peters can raise Harris' alleged misrepresentations as a defense against University.

c. 1. Cole's first claim is incorrect. The promissory note Cole executed is negotiable despite the reference to the construction contract, because it does not make the note subject to the other contract; rather, the reference is only a recital of that contract's existence.

2. Cole's second claim is incorrect. University acquired rights to the promissory note without Baker's indorsement because the note had been converted to a bearer instrument as a result of Able's blank indorsement. Bearer paper can be negotiated by delivery alone.

B. Documents of Title and Investment Securities

N89
Answer 5 (10 points)

West's assertion that Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability is incorrect. A shareholder of cumulative preferred stock is entitled to receive all dividend arrearages plus any dividends for the current year before any dividends may be distributed to the shareholders of common stock. However, preferred stock represents a contribution of capital, not a debt of the corporation, and until a dividend is declared, a shareholder of cumulative preferred stock is not a creditor of the corporation. Thus, Ace was correct in not classifying the dividend arrearages as a liability because a dividend was not declared by Ace's board of directors. Ace should disclose the dividend arrearages in notes to its financial statements.

West's assertion that West is entitled to examine Ace's books and records is correct. A shareholder, upon written demand, is entitled to examine, at reasonable times, the books and records of the corporation, so long as the examination is for a proper purpose (in good faith). If the corporation refuses to permit the examination, the shareholder may obtain a court order compelling access to the books and records.

West's assertion that West is entitled to receive a new stock certificate to replace the lost stock certificate is correct. Because the subject matter in this case is a stock certificate of a corporation, the UCC Investment Securities Article applies. Under that article, the stock certificate of Ace is classified as a certificated security because it is one of a class of Ace's shares that is represented by an instrument in West's name and is traded on a national securities exchange. If the owner of a certificated security claims that the security has been lost, the issuer shall issue a new certificated security, or, at the option of the issuer, an equivalent uncertificated security in place of the original security if the owner makes a request before the issuer has notice that the security has been acquired by a bona fide purchaser; files a sufficient indemnity bond with the issuer; and satisfies any other reasonable requirements imposed by the issuer. Based on the facts of this case, West is entitled to receive a new stock certificate because West requested that a new stock certificate be issued before Ace had notice the lost certificate was acquired by any other party; offered to file an indemnity bond with Ace; and offered to cooperate with any reasonable requests made by Ace.

C. Sales

N91
Answer 4 (10 points)

a. 1. Vesta Electronics would bear the risk of loss for the 18″ speakers destroyed by the fire on its loading dock. Even though Vesta identified and segregated the goods on its loading dock, the risk of loss remained with the seller because the contract's shipping terms "F.O.B. seller's loading dock" made it a shipping contract. Thus, risk of loss does not pass to Zap until the goods are delivered to the carrier.

2. The risk of loss for the 16″ speakers also remained with Vesta. Even though the goods were delivered to the common carrier, risk of loss did not pass because Vesta shipped nonconforming goods.

b. 1. Zap may validly reject the 16″ speakers because any buyer may reject nonconforming goods. To avoid potential liability, the rejection must be made within a reasonable time of receipt and must be communicated to the seller.

2. Zap may also validly accept some of the 18″ speakers. A buyer may accept none, all, or any commercial unit of a shipment when nonconforming goods are shipped.

c. To be entitled to damages, Zap must comply with the UCC by notifying Vesta of the rejection of the goods within a reasonable time; acting in good faith with respect to the rejected goods by following any reasonable instructions of the seller; and giving Vesta the opportunity to cure until the contract time of performance expires.

N90
Answer 4 (10 points)

a. Under the UCC Sales Article, the contract between Pharo and Secure creates the following implied warranties:

- Implied warranty of merchantability;
- Implied warranty of fitness for a particular purpose;
- Implied warranty of title.

The implied warranty of merchantability requires the tug to be merchantable; that is, fit for the ordinary purpose intended. It is probable that the tug was fit for such ordinary purposes and, therefore, the implied warranty of merchantability was not breached.

The implied warranty of fitness for a particular purpose requires that the tug be fit for the particular purpose for which it was purchased. To show that the implied warranty of fitness for a particular purpose is present as a result of the contract, Pharo must show that:

- Secure knew of the particular needs of Pharo;
- Pharo relied on Secure to select a suitable tug;
- Secure knew that Pharo was relying on Secure to select a tug suitable for Pharo's needs.

The implied warranty of fitness for a particular purpose has been breached because the tug was not suitable for Pharo's particular needs (i.e., to move airplanes weighing up to 10,000 pounds).

The implied warranty of title requires that:

- Secure have good title;
- The transfer to Pharo would be rightful;
- The tug would be delivered free from any security interest or other lien.

The implied warranty of title has been breached because Maco was the rightful owner.

b. Maco will not be entitled to recover the tug from Pharo because:

- Maco had entrusted the tug to Secure, which deals in similar goods;
- That, as a result of such entrustment, Secure had the power to transfer Maco's rights to the tug to a buyer in the ordinary course of business;

- Pharo was a buyer in the ordinary course of business because Pharo purchased the tug in good faith and without knowledge of Maco's ownership interest.

N89
Answer 4 (10 points)

The president's assertion that the September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and that, therefore, a contract was formed by Anker's acceptance on December 12, 1988, is incorrect. Because the offer made by Crisp involves a transaction in goods, i.e. furniture, the UCC Sales Article applies. The UCC Sales Article provides that an offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or, if no time is stated, for a reasonable time, but in no event may such period of irrevocability exceed three months. Under the facts of this case, Crisp's offer was a firm offer that could not be revoked because the offer was made by Crisp, a merchant, concerning the kind of goods being sold (furniture); was in writing and signed by Crisp; and stated that it would remain open until December 20, 1988. Despite the provision that the offer will remain open until December 20, 1988, a firm offer remains irrevocable for a three-month period. Therefore, Crisp's letter of revocation on December 5, 1988 did not terminate the firm offer because the three-month period had not yet expired. The revocation was effective on December 8, 1988, when the three-month period expired. Therefore, Anker's attempted acceptance on December 12, 1988 did not form a contract with Crisp. Instead, Anker's attempted acceptance is likely to be treated as an offer.

The president's assertion that Dix's December 12, 1988 letter formed an option contract is incorrect. To form an option contract, where the subject matter is real estate, all of the elements necessary to form a contract must be met. In this case, Anker did not furnish any consideration in return for Dix's promise to keep the offer open until December 20, 1988; therefore, an option contract was not formed.

The president's assertion that Anker's acceptance on December 19, 1988 formed a contract with Dix is incorrect. In general, acceptance of an offer is effective when it is dispatched. If, however, an offer specifically stipulates the method of communication to be utilized by the offeree, the acceptance to be effective must conform to that method. Thus, an acceptance by another method of communication is ineffective and no contract is formed. Under the facts of this case, Anker's acceptance on December 19, 1988 by a private express mail courier is ineffective, despite Dix's receipt of the acceptance on December 20, 1988, because Dix's offer specifically stipulated that acceptance could only be made by certified mail, return receipt requested. Instead, Anker's attempted acceptance is likely to be treated as a counteroffer.

M89
Answer 5 (10 points)

The assertion that as of March 3, 1989 the risk of loss on the disk drive remained with Xeon is correct. Under the UCC Sales Article, if the agreement between the parties is otherwise silent, risk of loss passes to the buyer on the buyer's receipt of the goods if the seller is a merchant. Under the facts, Xeon is a merchant because it sells computer systems. Therefore, the risk of loss remained with Xeon because the disk drive was never received by Pine.

The assertion that Meed acquired no rights in the CPU as a result of the March 18, 1989 transaction is incorrect. Under the UCC Sales Article, any entrusting of possession of goods to a merchant who deals in goods of that kind gives the merchant power to transfer all rights of the entruster to the buyer in the ordinary course of business. Entrusting includes any delivery and any acquiescence in retention of possession regardless of any condition expressed between the parties to the delivery or acquiescence, and regardless of whether the possessor's disposition of the goods has been such as to be larcenous under the criminal law. For the merchant to acquire the power to transfer ownership and title, the entruster must be the rightful owner. Under the facts of this case, Pine had title at the time the CPU was returned to Xeon for repairs and this constituted an entrusting that gave Xeon the power to transfer all of Pine's rights in the CPU to Meed.

The assertion that Jensen's security interest in the word processors never attached and therefore Jensen's security interest is not enforceable against Pine with respect to the word processors is incorrect. A security interest in collateral will attach if: the collateral is in the possession of the secured party under an agreement, or the debtor has signed a security agreement that contains a description of the collateral; the secured party has given value; and the debtor has rights in the collateral. Based on the facts, Jensen's security interest attached on April 12, 1989, when Jensen sold and Pine received the word processors and Jensen received a security agreement executed by Pine that described the word processors. On attachment, Jensen's security interest became enforceable against Pine.

The assertion that Jensen has a superior security interest to Pine's bank is incorrect. Although Jensen has a purchase money security interest to the extent the security interest is taken by Jensen to secure the purchase price, Jensen's security interest will not be perfected by attachment alone. Jensen must file a financing statement to perfect its security interest because the collateral involved is goods used for business purposes and not consumer goods. Therefore, Jensen has an unperfected security interest in the word processors and the bank obtained a superior security interest by perfecting.

N88
Answer 3 (10 points)

Dodd is entitled to recover workers' compensation benefits from Spear because Dodd was an employee of Salam, the injury was accidental, and the injury occurred out of and in the course of his employment with Salam. Based on the facts of this case, Dodd would be considered an employee and not an independent contractor because Salam had control over the details of Dodd's work by training Dodd to perform the services in a specified manner and Dodd was subject to Salam's supervision.

Dodd will be unsuccessful in his action against Salam based on negligence in training him because Dodd is an employee of Salam and Salam has complied with the applicable compulsory workers' compensation statute by obtaining workers' compensation insurance. Under workers' compensation, an employee who receives workers' compensation benefits cannot successfully maintain an action for negligence against his employer seeking additional compensation. Therefore, whether Salam was negligent in training Dodd is irrelevant.

Dodd's action against Ace based on strict liability in tort will be successful. Generally, in order to establish a cause of action based on strict liability in tort, it must be shown that: the product was in defective condition when it left the possession or control of the seller; the product was unreasonably dangerous to the consumer or user; the cause of the consumer's or user's injury was the defect; the seller engaged in the business of selling such a product; the product was one which the seller expected to, and, did reach the consumer or user without substantial changes in the condition in which it was sold. Under the facts of this case, Ace will be liable based on strict liability in tort because all of the elements necessary to state such a cause of action have been met. The fact that Dodd is entitled to workers' compensation benefits does not preclude Dodd from recovering based on strict liability in tort from a third party (Ace).

Maple will not be liable to the restaurant patrons based on negligence, because shareholders of a corporation are insulated from personal liability for the negligence of the corporation or the corporation's employees. This rule would apply even though Maple owned a controlling interest in the common stock of Salam. Therefore, whether Salam or Dodd was negligent is irrelevant.

M88
Answer 2 (10 points)

As of December 31, 1987, Spear bears the risk of loss for the computers on the December 20 contract with Pica. The shipping term "F.O.B.—Spear's loading dock" designates a shipment contract. In general, risk of loss passes to the buyer (Pica) in a shipment contract when the goods are duly delivered to the carrier. However, where a tender or delivery of goods so fails to conform to the contract as to give a right of rejection, the risk of their loss remains on the seller until cure or acceptance. Thus, the failure of the shipment to conform to the contract constitutes a breach that permits Pica to reject the computers, thereby resulting in Spear bearing the risk of loss for the computers while they are in transit.

With respect to the December 22 contract, the risk of loss as of December 31, 1987, remains with Spear. Unless otherwise agreed, the risk of loss in a sale on approval contract does not pass to the buyer until the buyer accepts the goods. Under the facts of this case, Rusk had not yet accepted the computers as of December 31, 1987. Therefore, the risk of loss on the computers as of December 31, 1987, remains with Spear.

As of December 31, 1987, Spear has title to the 15 computers purchased from Larson under the December 21 contract because a person with voidable title has the power to transfer good title to a good faith purchaser for value. Larson has voidable title because he paid for the computers with an insufficient funds check. Spear is a good faith purchaser for value because it paid Larson $20,000 and was unaware that Larson's check to Xeon was dishonored. The UCC Sales Article provides that when goods have been delivered under a transaction of purchase, the purchaser has the power to transfer good title even though the delivery was in exchange for a check that is later dishonored. Thus, Spear has good title to the computers as of December 31, 1987, despite Larson's check being dishonored, because it purchased and received the computers on December 21, 1987.

With respect to the December 22 sale on approval contract, title to the two computers remains with the seller until the buyer accepts the computers, because the contract is silent as to when title passes. Therefore, as of December 31, 1987, Spear retains title to the two computers because Rusk had not yet notified Spear whether it would accept the computers, and the time for such notification had not yet passed.

Because the December 22 contract between Spear and Rusk is a sale on approval contract, the computers are not subject to the claims of the creditors of the buyer (Rusk) until acceptance.

D. Secured Transactions

M92
Answer 5 (10 points)

Rustic's first claim, that its security interest is superior to National's, is incorrect. Rustic's security interest was perfected at the time it filed its financing statement, February 9, 1992, because it was a purchase money security interest in inventory. National filed its financing statement on February 7, 1992, therefore, National's security interest was perfected before, and is superior to, Rustic's security interest.

Rustic's second claim, that Karry purchased the lathe subject to Rustic's security interest, is incorrect. Karry, as a buyer in the ordinary course of Friendly's business, purchased the lathe free of any security interest given by Friendly. The fact that Karry was aware of Rustic's security interest does not affect this conclusion.

Karry's first claim, that the note is nonnegotiable, is incorrect. For a promissory note to be negotiable, it must be payable on demand or at a definite time. An instrument is payable on demand when it states that it is so payable, or when it provides no specific time for payment. Therefore, the note would be considered payable on demand.

Also, Karry's promissory note is negotiable despite the reference to the sales invoice because the reference does not make the note subject to the sales contract; rather, the reference only notes the existence of the invoice.

Karry's second claim, that Abcor has no rights to Karry's note because Friendly did not endorse it, is incorrect. The note is a bearer instrument because it is made payable to Friendly or bearer. Bearer instruments may be negotiated by delivery of the instrument alone.

Karry's third claim, that Abcor took the note subject to Karry's dispute with Friendly, is incorrect. Karry's dispute with Friendly was a personal defense to Karry. Even though Abcor took the note knowing of Karry's dispute and, therefore, could not ordinarily be a holder in due course, Abcor did take the note from Queen, which was a holder in due course. Under the "shelter provision" of the UCC Commercial Paper Article, Abcor has the rights of a holder in due course even though it does not qualify as one. As a result, Abcor did not take the note subject to Karry's personal defense, despite knowing of Karry's claim.

N91

Answer 5 (10 points)

Rice's assertion that Abco does not have an effective security interest in the CDM computer purchased by Rice is correct. For Abco to have an enforceable security interest in the collateral, the security interest claimed must have attached. Attachment requires that:

- The secured party (Abco) has given value;
- The debtor (Rice) has rights in the collateral; and
- The debtor (Rice) has executed and delivered to the creditor (Abco) a security agreement covering the collateral.

In this case, all but one of the requirements are met. The security agreement is ineffective because it was not signed by the debtor (Rice). Abco's failure to perfect its security interest by filing a financing statement would have no effect on the enforceability of the security interest against Rice.

Condor's assertion that its security interest in the computer is superior to Abco's is incorrect. Both Condor's and Abco's security interests are perfected. Condor's security interest was perfected when it filed its financing statement on August 26. Because Abco's security interest was a purchase money security interest in collateral other than inventory, its security interest was perfected at the time of the sale to Baker (August 18), provided it filed a financing statement at the time Baker took possession of the computer or within the UCC time period for perfection. Abco's security interest was perfected on August 18 before Condor's was perfected (on August 26), because Abco filed a financing statement within the applicable UCC time period. Therefore, Abco's security interest is superior to Condor's.

N90

Answer 5 (10 points)

Kast's assertion that the computer was purchased from Wizard free of National's security interest is correct. Kast, as a buyer in the ordinary course, purchased the computer free of any security interest given by Wizard. The fact that Kast was aware of the existence of National's security interest does not affect this conclusion.

Marc's assertion that the computer was purchased from Kast free of Wizard's security interest is correct. Marc purchased the computer from Kast free of Wizard's security interest because:

- Marc had no knowledge of the security interest;
- Marc was buying the computer for household use;
- Wizard's security interest had not been perfected by filing prior to Marc's purchase.

Marc's assertion that Alcor's security interest is unenforceable against Marc because Alcor failed to file a financing statement is incorrect. On attachment of Alcor's security interest, it became enforceable against Marc. Attachment has occurred because:

- The secured party (Alcor) gave value;
- The debtor (Marc) has rights in the collateral;
- The debtor (Marc) has executed and delivered a security agreement covering the collateral to the creditor (Alcor).

Alcor's failure to perfect its security interest has no effect on the enforceability of the security interest against Marc.

M88

Answer 4 (10 points)

A purchase money security interest is an interest in personal property or fixtures that secures payment or performance of an obligation and that is (1) taken or retained by the seller of the collateral to secure all or part of its price, or (2) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

Safe's security interest has priority over the rights of the trustee in bankruptcy. The UCC Article on Secured Transactions states that a lien creditor includes a trustee in bankruptcy from the date of the filing of the petition. Under the general rule, an unperfected security interest is subordinate to the rights of a person who becomes a lien creditor before the security interest is perfected. However, if the secured party files with respect to a purchase money security interest before or within 10 days after the debtor receives possession of the collateral, he takes priority over the rights of a lien creditor that arise between the time the security interest attaches and the time of filing. Under the facts of our case, Safe has a purchase money security interest in the equipment because the security interest was taken by Safe to secure the price. Therefore, because Safe filed a financing statement on May 14 (within 10 days after Lux received possession of the equipment) it has a priority security interest over the trustee in bankruptcy (lien creditor) whose claim arose between the time the security interest attached (May 5) and the time of filing (May 14).

Safe has a priority security interest in the equipment over City. A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within 10 days thereafter. Because Safe has a purchase money security interest in the equipment that was perfected by filing a financing statement on May 14 (within 10 days after Lux received possession of the equipment on May 5), Safe has a priority security interest over City despite City's perfection of its security interest on May 12.

Best's security interest in the inventory has priority over Safe's security interest. In general, conflicting perfected security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither a filing nor perfection. In this case, because both Best's and Safe's security interests were perfected by filing, the first to file (Best) will have a priority security interest. The fact that Best filed a financing statement prior to making the loan will not affect Best's priority.

Safe will not have a priority security interest over Dix because Dix is a buyer in the ordinary course of business and will take free of Safe's perfected security interest. Dix is a buyer in the ordinary course of business because Dix acted in good faith when purchasing the machine parts in the regular course of Cam's business. The UCC Article on Secured Transactions states that a buyer in the ordinary course of business takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence. Therefore, Dix will take the machine parts purchased from Cam's inventory on July 14, free from Safe's security interest which was perfected on July 12.

VII. Property

A. Real and Personal Property

N89
Answer 2 (10 points)

a. Sam Bean and Bob Bean will not be personally liable to Fale for the deficiency resulting from the foreclosure sale because they did not assume the mortgage but instead purchased the building subject to the mortgage. In the absence of a state statute to the contrary, Stein will be personally liable for the deficiency because Stein was not released from liability on the note and mortgage.

b. There is no right of survivorship feature in a tenancy in common and, therefore, Rita Bean will acquire Sam Bean's one-half interest in the building under her husband's will. Thus, Rita Bean will own a one-half interest in the building as a tenant in common with Bob Bean.

c. In general, the purposes and benefits of creating a spendthrift trust are to provide a fund for the maintenance of another (the beneficiary); protect the fund from the beneficiary's financial mismanagement and improvidence; prohibit the beneficiary from transferring the right to future trust income or principal; and prohibit the beneficiary's interest from being subjected to the claims of the beneficiary's creditors.

d.1. A trust may generally be terminated by the beneficiaries if all consent to the termination; all are legally competent to consent; and termination will not defeat a material purpose for which the trust was created.

2. The spendthrift trust created by Sam Bean cannot be terminated by Bob Bean because the major purpose of a spendthrift trust is to protect the beneficiary from mismanagement and improvidence. Thus, termination of the spendthrift trust would defeat the purpose for which it was created.

M89
Answer 3 (10 points)

a. Ash, Bale, and Rangel will be personally liable to Vista for the deficiency resulting from the foreclosure sale because they became the principal debtors when they assumed the mortgage. Park will remain liable for the deficiency. Although Vista consented to the assumption of the mortgage by Ash, Bale, and Rangel, such assumption does not relieve Park from its obligation to Vista unless Park obtains a release from Vista or there is a novation.

b. The assertion that the sublet from Wein to Nord is void because Ash, Bale, and Rangel must consent to the sublet is incorrect. Unless the lease provides otherwise, a tenant may sublet the premises without the landlord's consent. Since the lease was silent regarding Wein's right to sublet, Wein may sublet to Nord without the consent of Ash, Bale, and Rangel.

The assertion that if the sublet was not void Ash, Bale, and Rangel have the right to hold either Wein or Nord liable for payment of rent is incorrect. In a sublease, the sublessee/subtenant (Nord) has no obligation to pay rent to the landlord (Ash, Bale, and Rangel).

The subtenant (Nord) is liable to the tenant (Wein), but the tenant (Wein) remains solely liable to the landlord (Ash, Bale, and Rangel) for the rent stipulated in the lease.

c. Ash's inter vivos transfer of his $1/3$ interest in the office building to his spouse on April 4, 1989 resulted in his spouse obtaining a $1/3$ interest in the office building as a tenant in common. Ash's wife did not become a joint tenant with Bale and Rangel because the transfer of a joint tenant's interest to an outside party destroys the joint tenancy nature of the particular interest transferred. Bale and Rangel will remain as joint tenants with each other.

As of April 21, 1989, the office building was owned by Ash's spouse who had a $1/3$ interest as tenant in common and Bale who had a $2/3$ interest as tenant in common.

Ash's death on April 20, 1989 will have no effect on the ownership of the office building because Ash had already transferred all of his interest to his wife on April 4, 1989.

Rangel's death on April 20, 1989 resulted in his interest being acquired by Bale because of the right of survivorship feature in a joint tenancy. Because there are no surviving joint tenants, Bale will become a tenant in common who owns $2/3$ of the office building. Ash's spouse will not acquire any additional interest due to Rangel's death because she was a tenant in common with Rangel.

B. Mortgages

M91
Answer 4 (10 points)

a. Tower and Perry owned the property as tenants in common. This form of ownership allows either party to dispose of his or her undivided interest by sale or on death. Any person purchasing or inheriting Perry's interest would become a tenant in common with Tower. Thus, on January 21, 1990, Tower and Dodd are tenants in common, each owning a one-half undivided interest in the house.

b. Both Tower and Dodd have an insurable interest in the house. Tower's interest arose when the property was purchased, continued when the insurance policy was purchased, and still existed at the time of the fire loss.

Dodd's interest arose when Dodd inherited Perry's interest in the house. Acme's consent to the assignment of the policy to Tower and Dodd entitles Dodd to a share of the proceeds of the policy.

c. Acme would have to honor the insurance contract and pay part of the loss. Despite Tower and Perry not maintaining insurance coverage of 80% of the property's market value, the coinsurance clause allows for a percentage of recovery. The formula is as follows:

$$\frac{\text{Amount of Coverage}}{\text{Actual Market Value} \times \text{Coinsurance \%}} \times \begin{array}{c}\text{Amount}\\ \text{of Loss}\end{array}$$

This would allow a recovery as follows:

$$\frac{\$200{,}000}{\$300{,}000 \times .8} \times \$180{,}000 = \$150{,}000$$

d. The conflict between Midway and New would be resolved in favor of Midway. In a notice-race statute jurisdiction, New's knowledge of Midway's first mortgage would give Midway priority despite New's earlier filing. The insurance proceeds would be distributed as follows:

- $80,000 to Midway representing the balance due on the mortgage including accrued interest. This is due because Midway as a mortgagee is included as a contingent beneficiary in the policy.
- $40,000 to New for the same reasons as above but not paid unless and until Midway is fully paid.
- $30,000 to be divided equally between Tower and Dodd as tenants in common.

e. Tower would not be able to collect rent from Zimmer for the balance of the term of the lease because Zimmer moved as a result of the extensive fire damage to the apartment. The implied warranty of habitability would be considered breached by the landlord and a constructive eviction of Zimmer would be deemed to have taken place because the premises could no longer be used for their intended purpose. Constructive eviction releases both the landlord and the tenant from their obligations under the lease.

C. Fire and Casualty Insurance

N88
Answer 2 (10 points)

Starr's first assertion, that Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of $200,000, is correct. An oral agreement modifying an enforceable existing contract is not enforceable if the modification is within the statute of frauds. A contract for the sale of real estate or a modification of such a contract falls within the provisions of the statute of frauds and therefore a writing signed by the party to be charged is required. The fact that Birk sent a signed memo to Starr is not effective because it was not signed by Starr. Furthermore, the agreement to reduce the purchase price to $190,000 is not enforceable because Birk did not give any consideration for the modification. Birk had a pre-existing obligation to purchase the warehouse for $200,000 and gave no new consideration for the modification of the price. The fact that Birk may have acted in good faith as a result of the decline in value of real estate and rise in interest rates will not be sufficient to make the oral agreement enforceable against Starr. Therefore, Birk's failure to pay $200,000 as required by the July 1 contract constitutes a breach of that contract.

Starr's second assertion, that it has an insurable interest in the warehouse covered by the Pica policy, is correct. To constitute an insurable interest the element of financial or economic loss to the insured must be present. Furthermore, the insurable interest must be present at the time of the loss but need not be present at the time the policy was issued. Under the facts of this case, Starr had an insurable interest on the date of the loss (October 30) since it owned the warehouse on that date. Whether Starr had an insurable interest on February 15 will not affect Starr's right to recover from Pica.

Starr's third assertion, that it has met the coinsurance requirement under Pica's policy is correct.

Starr's fourth assertion, that Starr is entitled to recover the entire $80,000 from Pica is incorrect. Starr is only entitled to receive $64,000 from Pica calculated as follows:

$$\frac{\$160{,}000 \text{ (Amount of Insurance Coverage with Pica)}}{\$200{,}000 \text{ (Total Amount of Insurance on Warehouse)}} \times \$80{,}000 \text{ (Amount to be Paid)} = \$64{,}000$$

Thus, Pica's liability is limited to the amount its policy bears to the total amount of insurance on the warehouse.

Uniform CPA Examination

November 1992

Questions and Unofficial Answers

A Supplement to the Journal of Accountancy

November 1992

CONTENTS

Q-1

CANDIDATE NUMBER

Record your 7-digit candidate number in the boxes.

ACCOUNTING PRACTICE — PART I

November 4, 1992; 1:30 P.M. to 6:00 P.M.

The point values for each question, and estimated time allotments based primarily on point value, are as follows:

	Point Value	Estimated Minutes Minimum	Estimated Minutes Maximum
No. 1	10	45	55
No. 2	10	45	55
No. 3	10	45	55
No. 4	10	45	55
No. 5	10	40	50
Totals	50	220	270

INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

1. Record your 7-digit candidate number in the boxes provided at the upper right-hand corner of this page.

2. Question numbers 1, 2, 3, and 4a should be answered on the *Objective Answer Sheet,* which is pages 15 and 16 of your *Examination Answer Booklet*. You should attempt to answer all objective items. There is no penalty for incorrect responses. Work space to solve the objective questions is provided in this *Examination Question Booklet* on pages 3, 5, 7, 9, 11, and 13. Be certain that you have entered your answers on the *Objective Answer Sheet* before the examination time is up. The objective portion of your examination will not be graded if you fail to record your answers on the *Objective Answer Sheet*. You will not be given additional time to record your answers.

3. Question numbers 4b and 5 should be answered beginning on page 3 of the *Examination Answer Booklet*. Support **all** answers with properly labeled and legible calculations that can be identified as sources of amounts used to derive your final answer. If you have not completed answering a question on a page, fill in the appropriate spaces in the wording on the bottom of the page **"QUESTION NUMBER ___ CONTINUES ON PAGE ___."** If you have completed answering a question, fill in the appropriate space in the wording on the bottom of the page **"QUESTION NUMBER ___ ENDS ON THIS PAGE."** Always begin the start of an answer to a question on the top of a new page.

   Record your 7-digit candidate number, state, and question number where indicated on pages 3 through 14.

4. *Additional ruled paper* is available if you need it. Additional pages should be numbered 14a, 14b, 14c, etc. If you used additional pages record the number of pages used on page 14, insert additional pages between pages 12 and 13, close the booklet, and staple. Do not staple booklet unless you used additional ruled paper.

5. Although the primary purpose of the examination is to test your knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.

6. You are required to turn in by the end of each session:

   a. Attendance Record Form, front page of Examination Answer Booklet;
   b. Objective Answer Sheet, pages 15 and 16 of Examination Answer Booklet;
   c. Remaining Portion of Examination Answer Booklet;
   d. Examination Question Booklet; and
   e. All unused examination materials.

   Your examination will not be graded unless the above listed items are handed in before leaving the examination room.

7. Unless otherwise instructed, if you want your *Examination Question Booklet* mailed to you, write your name and address in both places indicated on the back cover and place 52 cents postage in the space provided. Examination Question Booklets will be distributed no sooner than the day following the administration of this examination.

Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands of the United States.

Instructions

Questions Number 1, 2, and 3 each consist of 20 multiple-choice items. Select the **best** answer for each of the items relating to **a variety of financial accounting problems**. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of correct answers.

Number 1 (Estimated time —— 45 to 55 minutes)

Items 1 through 3 are based on the following:

The following trial balance of Mint Corp. at December 31, 1991, has been adjusted except for income tax expense.

TRIAL BALANCE
December 31, 1991

	Dr.	*Cr.*
Cash	$ 600,000	
Accounts receivable, net	3,500,000	
Cost in excess of billings on long-term contracts	1,600,000	
Billings in excess of costs on long-term contracts		$ 700,000
Prepaid taxes	450,000	
Property, plant, and equipment, net	1,480,000	
Note payable — noncurrent		1,620,000
Common stock		750,000
Additional paid-in capital		2,000,000
Retained earnings — unappropriated		900,000
Retained earnings — restricted for note payable		160,000
Earnings from long-term contracts		6,680,000
Costs and expenses	5,180,000	
	$12,810,000	$12,810,000

Other financial data for the year ended December 31, 1991, are:

- Mint uses the percentage-of-completion method to account for long-term construction contracts for financial statement and income tax purposes. All receivables on these contracts are considered to be collectible within 12 months.
- During 1991, estimated tax payments of $450,000 were charged to prepaid taxes. Mint has not recorded income tax expense. There were no temporary or permanent differences, and Mint's tax rate is 30%.

In Mint's December 31, 1991, balance sheet, what amount should be reported as:

1. Total retained earnings?
   A. $1,950,000
   B. $2,110,000
   C. $2,400,000
   D. $2,560,000

2. Total noncurrent liabilities?
   A. $1,620,000
   B. $1,780,000
   C. $2,320,000
   D. $2,480,000

3. Total current assets?
   A. $5,000,000
   B. $5,450,000
   C. $5,700,000
   D. $6,150,000

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4. On December 30, 1991, Rafferty Corp. leased equipment under a capital lease. Annual lease payments of $20,000 are due December 31 for 10 years. The equipment's useful life is 10 years, and the interest rate implicit in the lease is 10%. The capital lease obligation was recorded on December 30, 1991, at $135,000, and the first lease payment was made on that date. What amount should Rafferty include in current liabilities for this capital lease in its December 31, 1991, balance sheet?
   A. $ 6,500
   B. $ 8,500
   C. $11,500
   D. $20,000

5. Able, Inc. had the following amounts of long-term debt outstanding at December 31, 1991:

14½% term note, due 1992	$ 3,000
11⅛% term note, due 1995	107,000
8% note, due in 11 equal annual principal payments, plus interest beginning December 31, 1992	110,000
7% guaranteed debentures, due 1996	100,000
Total	$320,000

Able's annual sinking-fund requirement on the guaranteed debentures is $4,000 per year. What amount should Able report as current maturities of long-term debt in its December 31, 1991, balance sheet?
   A. $ 4,000
   B. $ 7,000
   C. $10,000
   D. $13,000

6. Rice Co. was incorporated on January 1, 1991, with $500,000 from the issuance of stock and borrowed funds of $75,000. During the first year of operations, net income was $25,000. On December 15, Rice paid a $2,000 cash dividend. No additional activities affected owners' equity in 1991. At December 31, 1991, Rice's liabilities had increased to $94,000. In Rice's December 31, 1991, balance sheet, total assets should be reported at
   A. $598,000
   B. $600,000
   C. $617,000
   D. $692,000

7. On September 1, 1992, Hyde Corp., a newly formed company, had the following stock issued and outstanding:

- Common stock, no par, $1 stated value, 5,000 shares originally issued for $15 per share.
- Preferred stock, $10 par value, 1,500 shares originally issued for $25 per share.

Hyde's September 1, 1992, statement of stockholders' equity should report

	Common stock	*Preferred stock*	*Additional paid-in capital*
A.	$ 5,000	$15,000	$92,500
B.	$ 5,000	$37,500	$70,000
C.	$75,000	$37,500	$0
D.	$75,000	$15,000	$22,500

8. Tack, Inc. reported a retained earnings balance of $150,000 at December 31, 1990. In June 1991, Tack discovered that merchandise costing $40,000 had not been included in inventory in its 1990 financial statements. Tack has a 30% tax rate. What amount should Tack report as adjusted beginning retained earnings in its statement of retained earnings at December 31, 1991?
   A. $190,000
   B. $178,000
   C. $150,000
   D. $122,000

MULTIPLE-CHOICE WORK SPACE

This information will **not** be graded. Only answers recorded on the Objective Answer Sheet will be graded.

Items 9 through 13 are based on the following:

Flax Corp. uses the direct method to prepare its statement of cash flows. Flax's trial balances at December 31, 1991 and 1990, are as follows:

	December 31	
	1991	*1990*
Debits:		
Cash	$ 35,000	$ 32,000
Accounts receivable	33,000	30,000
Inventory	31,000	47,000
Property, plant, & equipment	100,000	95,000
Unamortized bond discount	4,500	5,000
Cost of goods sold	250,000	380,000
Selling expenses	141,500	172,000
General and administrative expenses	137,000	151,300
Interest expense	4,300	2,600
Income tax expense	20,400	61,200
	$756,700	$976,100
Credits:		
Allowance for uncollectible accounts	$ 1,300	$ 1,100
Accumulated depreciation	16,500	15,000
Trade accounts payable	25,000	17,500
Income taxes payable	21,000	27,100
Deferred income taxes	5,300	4,600
8% callable bonds payable	45,000	20,000
Common stock	50,000	40,000
Additional paid-in capital	9,100	7,500
Retained earnings	44,700	64,600
Sales	538,800	778,700
	$756,700	$976,100

- Flax purchased $5,000 in equipment during 1991.
- Flax allocated one-third of its depreciation expense to selling expenses and the remainder to general and administrative expenses.

What amounts should Flax report in its statement of cash flows for the year ended December 31, 1991, for the following:

9. Cash collected from customers?
   A. $541,800
   B. $541,600
   C. $536,000
   D. $535,800

10. Cash paid for goods to be sold?
   A. $258,500
   B. $257,500
   C. $242,500
   D. $226,500

11. Cash paid for interest?
   A. $4,800
   B. $4,300
   C. $3,800
   D. $1,700

12. Cash paid for income taxes?
   A. $25,800
   B. $20,400
   C. $19,700
   D. $15,000

13. Cash paid for selling expenses?
   A. $142,000
   B. $141,500
   C. $141,000
   D. $140,000

Items 14 through 18 are based on the following:

Selected information from the separate and consolidated balance sheets and income statements of Pard, Inc. and its subsidiary, Spin Co., as of December 31, 1991, and for the year then ended is as follows:

	Pard	*Spin*	*Consolidated*
Balance sheet accounts			
Accounts receivable	$ 26,000	$ 19,000	$ 39,000
Inventory	30,000	25,000	52,000
Investment in Spin	67,000	—	—
Goodwill	—	—	30,000
Minority interest	—	—	10,000
Stockholders' equity	154,000	50,000	154,000
Income statement accounts			
Revenues	$200,000	$140,000	$308,000
Cost of goods sold	150,000	110,000	231,000
Gross profit	50,000	30,000	77,000
Equity in earnings of Spin	11,000	—	—
Amortization of goodwill	—	—	2,000
Net income	36,000	20,000	40,000

Additional information:

- During 1991, Pard sold goods to Spin at the same markup on cost that Pard uses for all sales. At December 31, 1991, Spin had not paid for all of these goods and still held 37.5% of them in inventory.
- Pard acquired its interest in Spin on January 2, 1988. Pard's policy is to amortize goodwill by the straight-line method.

14. What was the amount of intercompany sales from Pard to Spin during 1991?
   A. $ 3,000
   B. $ 6,000
   C. $29,000
   D. $32,000

15. At December 31, 1991, what was the amount of Spin's payable to Pard for intercompany sales?
   A. $ 3,000
   B. $ 6,000
   C. $29,000
   D. $32,000

16. In Pard's consolidated balance sheet, what was the carrying amount of the inventory that Spin purchased from Pard?
   A. $ 3,000
   B. $ 6,000
   C. $ 9,000
   D. $12,000

17. What is the percent of minority interest ownership in Spin?
   A. 10%
   B. 20%
   C. 25%
   D. 45%

18. Over how many years has Pard chosen to amortize goodwill?
   A. 15
   B. 19
   C. 23
   D. 40

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19. Information regarding Pinn, Inc.'s noncurrent investments in marketable equity securities at December 31, 1991 and 1990, follows:

	1991	*1990*
Cost	$275,000	$350,000
Allowance for decline in value	37,000	25,000

What amount should Pinn report in its December 31, 1991, balance sheet as the net unrealized loss on noncurrent marketable equity securities?
   A. $0
   B. $12,000
   C. $37,000
   D. $87,000

20. On July 1, 1991, Balt Co. exchanged a truck for 25 shares of Ace Corp.'s common stock. On that date, the truck's carrying amount was $2,500, and its fair value was $3,000. Also, the book value of Ace's stock was $60 per share. On December 31, 1991, Ace had 250 shares of common stock outstanding and its book value per share was $50. What amount should Balt report in its December 31, 1991, balance sheet as investment in Ace?
   A. $3,000
   B. $2,500
   C. $1,500
   D. $1,250

MULTIPLE-CHOICE WORK SPACE

This information will **not** be graded. Only answers recorded on the Objective Answer Sheet will be graded.

Number 2 (Estimated time —— 45 to 55 minutes)

21. Rabb Co. records its purchases at gross amounts but wishes to change to recording purchases net of purchase discounts. Discounts available on purchases recorded from October 1, 1991, to September 30, 1992, totaled $2,000. Of this amount, $200 is still available in the accounts payable balance. The balances in Rabb's accounts as of and for the year ended September 30, 1992, before conversion are:

Purchases	$100,000
Purchase discounts taken	800
Accounts payable	30,000

What is Rabb's accounts payable balance as of September 30, 1992, after the conversion?

A. $29,800
B. $29,200
C. $28,800
D. $28,200

22. On August 1, 1991, Vann Corp.'s $500,000, one-year, noninterest-bearing note due July 31, 1992, was discounted at Homestead Bank at 10.8%. Vann uses the straight-line method of amortizing bond discount. What amount should Vann report for notes payable in its December 31, 1991, balance sheet?

A. $500,000
B. $477,500
C. $468,500
D. $446,000

23. On November 1, 1991, Mason Corp. issued $800,000 of its 10-year, 8% term bonds dated October 1, 1991. The bonds were sold to yield 10%, with total proceeds of $700,000 plus accrued interest. Interest is paid every April 1 and October 1. What amount should Mason report for interest payable in its December 31, 1991, balance sheet?

A. $17,500
B. $16,000
C. $11,667
D. $10,667

24. Case Cereal Co. frequently distributes coupons to promote new products. On October 1, 1991, Case mailed 1,000,000 coupons for $.45 off each box of cereal purchased. Case expects 120,000 of these coupons to be redeemed before the December 31, 1991, expiration date. It takes 30 days from the redemption date for Case to receive the coupons from the retailers. Case reimburses the retailers an additional $.05 for each coupon redeemed. As of December 31, 1991, Case had paid retailers $25,000 related to these coupons and had 50,000 coupons on hand that had not been processed for payment. What amount should Case report as a liability for coupons in its December 31, 1991, balance sheet?

A. $35,000
B. $29,000
C. $25,000
D. $22,500

25. Nome Co. sponsors a defined benefit plan covering all employees. Benefits are based on years of service and compensation levels at the time of retirement. Nome determined that, as of September 30, 1992, its accumulated benefit obligation was $380,000, and its plan assets had a $290,000 fair value. Nome's September 30, 1992, trial balance showed prepaid pension cost of $20,000. In its September 30, 1992, balance sheet, what amount should Nome report as additional pension liability?

A. $110,000
B. $360,000
C. $380,000
D. $400,000

26. Barnel Corp. owns and manages 19 apartment complexes. On signing a lease, each tenant must pay the first and last months' rent and a $500 refundable security deposit. The security deposits are rarely refunded in total, because cleaning costs of $150 per apartment are almost always deducted. About 30% of the time, the tenants are also charged for damages to the apartment, which typically cost $100 to repair. If a one-year lease is signed on a $900 per month apartment, what amount would Barnel report as refundable security deposit?

A. $1,400
B. $ 500
C. $ 350
D. $ 320

27. For the year ended December 31, 1991, Mont Co.'s books showed income of $600,000 before provision for income tax expense. To compute taxable income for federal income tax purposes, the following items should be noted:

Income from exempt municipal bonds	$ 60,000
Depreciation deducted for tax purposes in excess of depreciation recorded on the books	120,000
Proceeds received from life insurance on death of officer	100,000
Estimated tax payments	0
Enacted corporate tax rate	30%

Ignoring the alternative minimum tax provisions, what amount should Mont report at December 31, 1991, as its current federal income tax liability?

A. $ 96,000
B. $114,000
C. $150,000
D. $162,000

28. Gant Co., which began operations on January 1, 1991, appropriately uses the installment method of accounting. The following information pertains to Gant's operations for the year 1991:

Installment sales	$500,000
Regular sales	300,000
Cost of installment sales	250,000
Cost of regular sales	150,000
General and administrative expenses	50,000
Collections on installment sales	100,000

In its December 31, 1991, balance sheet, what amount should Gant report as deferred gross profit?

A. $250,000
B. $200,000
C. $160,000
D. $ 75,000

29. Toddler Care Co. offers three payment plans on its 12-month contracts. Information on the three plans and the number of children enrolled in each plan for the September 1, 1991, through August 31, 1992, contract year follows:

Plan	*Initial payment per child*	*Monthly fees per child*	*Number of children*
#1	$500	$—	15
#2	200	30	12
#3	—	50	9
			36

Toddler received $9,900 of initial payments on September 1, 1991, and $3,240 of monthly fees during the period September 1 through December 31, 1991. In its December 31, 1991, balance sheet, what amount should Toddler report as deferred revenues?

A. $3,300
B. $4,380
C. $6,600
D. $9,900

30. Regal Department Store sells gift certificates, redeemable for store merchandise, that expire one year after their issuance. Regal has the following information pertaining to its gift certificates sales and redemptions:

Unredeemed at 12/31/90	$ 75,000
1991 sales	250,000
1991 redemptions of prior year sales	25,000
1991 redemptions of current year sales	175,000

Regal's experience indicates that 10% of gift certificates sold will not be redeemed. In its December 31, 1991, balance sheet, what amount should Regal report as unearned revenue?

A. $125,000
B. $112,500
C. $100,000
D. $ 50,000

MULTIPLE-CHOICE WORK SPACE

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31. During 1990, Manfred Corp. guaranteed a supplier's $500,000 loan from a bank. On October 1, 1991, Manfred was notified that the supplier had defaulted on the loan and filed for bankruptcy protection. Counsel believes Manfred will probably have to pay between $250,000 and $450,000 under its guarantee. As a result of the supplier's bankruptcy, Manfred entered into a contract in December 1991 to retool its machines so that Manfred could accept parts from other suppliers. Retooling costs are estimated to be $300,000. What amount should Manfred report as a liability in its December 31, 1991, balance sheet?
   A. $250,000
   B. $450,000
   C. $550,000
   D. $750,000

32. Tower Corp. began operations on January 1, 1990. For financial reporting, Tower recognizes revenues from all sales under the accrual method. However, in its income tax returns, Tower reports qualifying sales under the installment method. Tower's gross profit on these installment sales under each method was as follows:

Year	*Accrual method*	*Installment method*
1990	$1,600,000	$ 600,000
1991	2,600,000	1,400,000

The income tax rate is 30% for 1990 and future years. There are no other temporary or permanent differences. In its December 31, 1991, balance sheet, what amount should Tower report as a liability for deferred income taxes?
   A. $840,000
   B. $660,000
   C. $600,000
   D. $360,000

33. On December 29, 1991, Action Corp. signed a 7-year capital lease for an airplane to transport its sports team around the country. The airplane's fair value was $841,500. Action made the first annual lease payment of $153,000 on December 31, 1991. Action's incremental borrowing rate was 12%, and the interest rate implicit in the lease, which was known by Action, was 9%. The following are the rounded present value factors for an annuity due:

9% for 7 years	5.5
12% for 7 years	5.1

What amount should Action report as capital lease liability in its December 31, 1991, balance sheet?
   A. $841,500
   B. $780,300
   C. $688,500
   D. $627,300

34. On December 30, 1990, Ames Co. leased equipment under a capital lease for 10 years. It contracted to pay $40,000 annual rent on December 31, 1990, and on December 31 of each of the next nine years. The capital lease liability was recorded at $270,000 on December 30, 1990, before the first payment. The equipment's useful life is 12 years, and the interest rate implicit in the lease is 10%. Ames uses the straight-line method to depreciate all equipment. In recording the December 31, 1991, payment, by what amount should Ames reduce the capital lease liability?
   A. $27,000
   B. $23,000
   C. $22,500
   D. $17,000

35. On June 30, 1992, Lang Co. sold equipment with an estimated useful life of eleven years and immediately leased it back for ten years. The equipment's carrying amount was $450,000; the sales price was $430,000; and the present value of the lease payments, which is equal to the fair value of the equipment, was $465,000. In its June 30, 1992, balance sheet, what amount should Lang report as deferred loss?
   A. $35,000
   B. $20,000
   C. $15,000
   D. $0

36. On April 1, 1992, Hill Corp. issued 200 of its $1,000 face value bonds at 101 plus accrued interest. The bonds were dated November 1, 1991, and bear interest at an annual rate of 9% payable semiannually on November 1 and May 1. What amount did Hill receive from the bond issuance?
   A. $194,500
   B. $200,000
   C. $202,000
   D. $209,500

37. During 1992, Lake Co. issued 3,000 of its 9%, $1,000 face value bonds at 101½. In connection with the sale of these bonds, Lake paid the following expenses:

Promotion costs	$ 20,000
Engraving and printing	25,000
Underwriters' commissions	200,000

What amount should Lake record as bond issue costs to be amortized over the term of the bonds?
   A. $0
   B. $220,000
   C. $225,000
   D. $245,000

38. On May 1, 1992, Bolt Corp. issued 11% bonds in the face amount of $1,000,000 that mature on May 1, 2002. The bonds were issued to yield 10%, resulting in bond premium of $62,000. Bolt uses the effective interest method of amortizing bond premium. Interest is payable semiannually on November 1 and May 1. In its October 31, 1992, balance sheet, what amount should Bolt report as unamortized bond premium?

A. $62,000
B. $60,100
C. $58,900
D. $58,590

39. Blue Corp.'s December 31, 1991, balance sheet contained the following items in the long-term liabilities section:

9¾% registered debentures, callable in 2002, due in 2007	$700,000
9½% collateral trust bonds, convertible into common stock beginning in 2000, due in 2010	600,000
10% subordinated debentures ($30,000 maturing annually beginning in 1997)	300,000

What is the total amount of Blue's term bonds?

A. $ 600,000
B. $ 700,000
C. $1,000,000
D. $1,300,000

40. On April 1, 1992, Ash Corp. began offering a new product for sale under a one-year warranty. Of the 5,000 units in inventory at April 1, 1992, 3,000 had been sold by June 30, 1992. Based on its experience with similar products, Ash estimated that the average warranty cost per unit sold would be $8. Actual warranty costs incurred from April 1 through June 30, 1992, were $7,000. At June 30, 1992, what amount should Ash report as estimated warranty liability?

A. $ 9,000
B. $16,000
C. $17,000
D. $33,000

MULTIPLE-CHOICE WORK SPACE

This information will **not** be graded. Only answers recorded on the Objective Answer Sheet will be graded.

Number 3 (Estimated time —— 45 to 55 minutes)

41. Reid Partners, Ltd., which began operations on January 1, 1990, has elected to use cash-basis accounting for tax purposes and accrual-basis accounting for its financial statements. Reid reported sales of $175,000 and $80,000 in its tax returns for the years ended December 31, 1991 and 1990, respectively. Reid reported accounts receivable of $30,000 and $50,000 in its balance sheets as of December 31, 1991 and 1990, respectively. What amount should Reid report as sales in its income statement for the year ended December 31, 1991?

A. $145,000
B. $155,000
C. $195,000
D. $205,000

42. Lance Corp.'s statement of cash flows for the year ended September 30, 1992, was prepared using the indirect method and included the following:

Net income	$60,000
Noncash adjustments:	
Depreciation expense	9,000
Increase in accounts receivable	(5,000)
Decrease in inventory	40,000
Decrease in accounts payable	(12,000)
Net cash flows from operating activities	$92,000

Lance reported revenues from customers of $75,000 in its 1992 income statement. What amount of cash did Lance receive from its customers during the year ended September 30, 1992?

A. $80,000
B. $70,000
C. $65,000
D. $55,000

43. Several of Fox, Inc.'s customers are having cash flow problems. Information pertaining to these customers for the years ended March 31, 1991 and 1992, follows:

	3/31/91	*3/31/92*
Sales	$10,000	$15,000
Cost of sales	8,000	9,000
Cash collections		
on 1991 sales	7,000	3,000
on 1992 sales	—	12,000

If the cost recovery method is used, what amount would Fox report as gross profit from sales to these customers for the year ended March 31, 1992?

A. $ 2,000
B. $ 3,000
C. $ 5,000
D. $15,000

44. Information pertaining to dividends from Wray Corp.'s common stock investments for the year ended December 31, 1991, follows:

- On September 8, 1991, Wray received a $50,000 cash dividend from Seco, Inc., in which Wray owns a 30% interest. A majority of Wray's directors are also directors of Seco.
- On October 15, 1991, Wray received a $6,000 liquidating dividend from King Co. Wray owns a 5% interest in King Co.
- Wray owns a 2% interest in Bow Corp., which declared a $200,000 cash dividend on November 27, 1991, to stockholders of record on December 15, 1991, payable on January 5, 1992.

What amount should Wray report as dividend income in its income statement for the year ended December 31, 1991?

A. $60,000
B. $56,000
C. $10,000
D. $ 4,000

45. Conn Corp. owns an office building and normally charges tenants $30 per square foot per year for office space. Because the occupancy rate is low, Conn agreed to lease 10,000 square feet to Hanson Co. at $12 per square foot for the first year of a three-year operating lease. Rent for remaining years will be at the $30 rate. Hanson moved into the building on January 1, 1992, and paid the first year's rent in advance. What amount of rental revenue should Conn report from Hanson in its income statement for the year ended September 30, 1992?

A. $ 90,000
B. $120,000
C. $180,000
D. $240,000

46. Dahl Co. traded a delivery van and $5,000 cash for a newer van owned by West Corp. The following information relates to the values of the vans on the exchange date:

	Carrying value	*Fair value*
Old van	$30,000	$45,000
New van	40,000	50,000

Dahl's income tax rate is 30%. What amounts should Dahl report as gain on exchange of the vans?

A. $15,000
B. $ 1,000
C. $ 700
D. $0

47. On June 30, 1992, King Co. had outstanding 9%, $5,000,000 face value bonds maturing on June 30, 1997. Interest was payable semiannually every June 30 and December 31. On June 30, 1992, after amortization was recorded for the period, the unamortized bond premium and bond issue costs were $30,000 and $50,000, respectively. On that date, King acquired all its outstanding bonds on the open market at 98 and retired them. At June 30, 1992, what amount should King recognize as gain before income taxes on redemption of bonds?
   A. $ 20,000
   B. $ 80,000
   C. $120,000
   D. $180,000

Items 48 through 50 are based on the following:

On December 12, 1991, Imp Co. entered into three forward exchange contracts, each to purchase 100,000 francs in 90 days. The relevant exchange rates are as follows:

	Spot rate	*Forward rate (for March 12, 1992)*
December 12, 1991	$.88	$.90
December 31, 1991	.98	.93

48. Imp entered into the first forward contract to hedge a purchase of inventory in November 1991, payable in March 1992. At December 31, 1991, what amount of foreign currency transaction gain should Imp include in income from this forward contract?
   A. $0
   B. $ 3,000
   C. $ 5,000
   D. $10,000

49. Imp entered into the second forward contract to hedge a commitment to purchase equipment being manufactured to Imp's specifications. At December 31, 1991, what amount of foreign currency transaction gain should Imp include in income from this forward contract?
   A. $0
   B. $ 3,000
   C. $ 5,000
   D. $10,000

50. Imp entered into the third forward contract for speculation. At December 31, 1991, what amount of foreign currency transaction gain should Imp include in income from this forward contract?
   A. $0
   B. $ 3,000
   C. $ 5,000
   D. $10,000

MULTIPLE-CHOICE WORK SPACE

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51. In 1986, Chain, Inc. purchased a $1,000,000 life insurance policy on its president, of which Chain is the beneficiary. Information regarding the policy for the year ended December 31, 1991, follows:

Cash surrender value, 1/1/91	$ 87,000
Cash surrender value, 12/31/91	108,000
Annual advance premium paid 1/1/91	40,000

During 1991, dividends of $6,000 were applied to increase the cash surrender value of the policy. What amount should Chain report as life insurance expense for 1991?

A. $40,000
B. $25,000
C. $19,000
D. $13,000

52. Kent Co.'s advertising expense account had a balance of $292,500 at December 31, 1991, before any necessary year-end adjustment relating to the following:

- Included in the $292,500 is the $30,000 cost of printing catalogs for a sales promotional campaign in January 1992.
- Radio advertising spots broadcast during December 1991 were billed to Kent on January 2, 1992. Kent paid the $17,500 invoice on January 11, 1992.

What amount should Kent report as advertising expense in its income statement for the year ended December 31, 1991?

A. $310,000
B. $280,000
C. $262,500
D. $245,000

53. Heller Co. incurred the following costs in 1991:

Research and development services performed by Kay Corp. for Heller	$150,000
Testing for evaluation of new products	125,000
Laboratory research aimed at discovery of new knowledge	185,000

What amount should Heller report as research and development costs in its income statement for the year ended December 31, 1991?

A. $125,000
B. $150,000
C. $335,000
D. $460,000

54. Canary Corp. bases its provision for depletion of coal properties on estimates of recoverable reserves using the units-of-production method. The unit rate for depletion is determined by dividing the total unrecovered carrying value of coal properties by the proved reserves. Canary's coal properties had proved reserves of 3,000,000 tons when they were acquired for $15,000,000. On January 1, 1991, proved reserves were estimated at 2,000,000 tons and had an unrecovered carrying value of $11,000,000. During 1991, Canary produced 350,000 tons of coal and sold 400,000 tons. What amount should Canary report as depletion expense in its income statement for the year ended December 31, 1991?

A. $2,200,000
B. $2,000,000
C. $1,925,000
D. $1,750,000

55. On January 2, 1991, Cole Co. signed an eight-year noncancelable lease for a new machine, requiring $15,000 annual payments at the beginning of each year. The machine has a useful life of 12 years, with no salvage value. Title passes to Cole at the lease expiration date. Cole use straight-line depreciation for all of its plant assets. Aggregate lease payments have a present value on January 2, 1991, of $108,000, based on an appropriate rate of interest. For 1991, Cole should record depreciation (amortization) expense for the leased machine at

A. $0
B. $ 9,000
C. $13,500
D. $15,000

56. On December 1, 1991, Clark Co. leased office space for five years at a monthly rental of $60,000. On the same date, Clark paid the lessor the following amounts:

First month's rent	$ 60,000
Last month's rent	60,000
Security deposit (refundable at lease expiration)	80,000
Installation of new walls and offices	360,000

What should be Clark's 1991 expense relating to utilization of the office space?

A. $ 60,000
B. $ 66,000
C. $120,000
D. $140,000

57. On January 1, 1991, Harrow Co. as lessee signed a five-year noncancellable equipment lease with annual payments of $100,000 beginning December 31, 1991. Harrow treated this transaction as a capital lease. The five lease payments have a present value of $379,000 at January 1, 1991, based on interest of 10%. What amount should Harrow report as interest expense for the year ended December 31, 1991?

A. $37,900
B. $27,900
C. $24,200
D. $0

58. On January 1, 1991, Baker Co. decided to grant its employees 10 vacation days and five sick days each year. Sick days may not be carried over to the next year. Each employee took an average of three sick days in 1991. During 1991, each of Baker's six employees earned $100 per day and earned 10 vacation days. These vacation days were taken during 1992. What amount should Baker report for compensated absence expense for the year ended December 31, 1991?

A. $0
B. $6,000
C. $7,200
D. $9,000

59. On October 15, 1991, Kam Corp. informed Finn Co. that Kam would be unable to repay its $100,000 note due on October 31 to Finn. Finn agreed to accept title to Kam's computer equipment in full settlement of the note. The equipment's carrying value was $80,000 and its fair value was $75,000. Kam's tax rate is 30%. What amounts should Kam report as ordinary gain (loss) and extraordinary gain for the year ended September 30, 1992?

	Ordinary gain (loss)	*Extraordinary gain*
A.	$(5,000)	$17,500
B.	$0	$20,000
C.	$0	$14,000
D.	$20,000	$0

60. Milton Co. began operations on January 1, 1989. On January 1, 1991, Milton changed its inventory method from LIFO to FIFO for both financial and income tax reporting. If FIFO had been used in prior years, Milton's inventories would have been higher by $60,000 and $40,000 at December 31, 1991 and 1990, respectively. Milton has a 30% income tax rate. What amount should Milton report as the cumulative effect of this accounting change in its income statement for the year ended December 31, 1991?

A. $0
B. $14,000
C. $28,000
D. $42,000

MULTIPLE-CHOICE WORK SPACE

This information will **not** be graded. Only answers recorded on the Objective Answer Sheet will be graded.

Number 4 (Estimated time —— 45 to 55 minutes)

Number 4 consists of two unrelated parts.

Instructions — Number 4(a)

Question Number 4(a) consists of 8 items. Select the **best** answer for each item. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Answer all items.** Your grade will be based on the total number of correct answers.

During 1992, Sloan, Inc. began a project to construct new corporate headquarters. Sloan purchased land with an existing building for $750,000. The land was valued at $700,000 and the building at $50,000. Sloan planned to demolish the building and construct a new office building on the site. Items 61 through 68 represent various expenditures by Sloan for this project.

Required:
For each expenditure in Items 61 through 68, select from the list below the appropriate accounting treatment and blacken the corresponding oval on the Objective Answer Sheet.

L. Classify as land and do not depreciate.
B. Classify as building and depreciate.
E. Expense.

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

Item

99. Architect's fees of $100,000.

Answer Sheet

Item	Land	Building	Expense
99	Ⓛ	●	Ⓔ

Items to be Answered:

61. Purchase of land for $700,000.
62. Interest of $147,000 on construction financing incurred after completion of construction.
63. Interest of $186,000 on construction financing paid during construction.
64. Purchase of building for $50,000.
65. $18,500 payment of delinquent real estate taxes assumed by Sloan on purchase.
66. $12,000 liability insurance premium during the construction period.
67. $65,000 cost of razing existing building.
68. Moving costs of $136,000.

Number 4(b)

On January 1, 1989, Silver Industries, Inc. adopted the dollar-value LIFO method of determining inventory costs for financial and income tax reporting. The following information relates to this change:

- Silver has continued to use the FIFO method, which approximates current costs, for internal reporting purposes. Silver's FIFO inventories at December 31, 1989, 1990, and 1991 were $100,000, $137,500, and $195,000, respectively.
- The FIFO inventory amounts are converted to dollar-value LIFO amounts using a single inventory pool and cost indices developed using the link-chain method. Silver estimated that the current year cost change indices, which measure year-to-year cost changes, were 1.25 for 1990 and 1.20 for 1991.

Required:
Prepare a schedule showing the computation of Silver's dollar-value LIFO inventory at December 31, 1990 and 1991. Show all calculations.

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

The following condensed trial balance of Powell Corp., a publicly-owned company, has been adjusted except for income tax expense:

Powell Corp.
CONDENSED TRIAL BALANCE
June 30, 1992

	Debit	*Credit*
Total assets	$25,080,000	
Total liabilities		$ 9,900,000
5% cumulative preferred stock		2,000,000
Common stock		10,000,000
Retained earnings		2,900,000
Machine sales		750,000
Service revenues		250,000
Interest revenue		10,000
Gain on sale of factory		250,000
Cost of sales—machines	425,000	
Cost of services	100,000	
Administrative expenses	300,000	
Research and development expenses	110,000	
Interest expense	5,000	
Loss from asset disposal	40,000	
	$26,060,000	$26,060,000

Other information and financial data for the year ended June 30, 1992, follows:

- The weighted average number of common shares outstanding during 1992 was 200,000. The potential dilution from the exercise of stock options held by Powell's officers and directors was not material.
- There were no dividends-in-arrears on Powell's preferred stock at July 1, 1991. On May 1, 1992, Powell's directors declared a 5% preferred stock dividend to be paid in August 1992.
- During 1992, one of Powell's foreign factories was expropriated by the foreign government, and Powell received a $900,000 payment from the foreign government in settlement. The carrying value of the plant was $650,000. Powell has never disposed of a factory.
- Administrative expenses includes a $5,000 premium payment for a $1,000,000 life insurance policy on Powell's president, of which the corporation is the beneficiary.
- Powell depreciates its assets using the straight-line method for financial reporting purposes and an accelerated method for tax purposes. The differences between book and tax depreciation are as follows:

June 30	*Financial statements over (under) tax depreciation*
1992	$(15,000)
1993	10,000
1994	5,000

  There were no other temporary differences.

- Powell's enacted tax rate for the current and future years is 30%. Powell elected early application of FASB Statement No. 96, *Accounting for Income Taxes.*

Required:

a. Using the single-step format, prepare Powell's income statement for the year ended June 30, 1992.

b. Prepare a schedule reconciling Powell's financial statement net income to taxable income for the year ended June 30, 1992.

ACCOUNTING PRACTICE — PART II

Q-2

CANDIDATE NUMBER

Record your 7-digit candidate number in the boxes.

November 5, 1992; 1:30 P.M. to 6:00 P.M.

The point values for each question, and estimated time allotments based primarily on point value, are as follows:

	Point Value	Estimated Minutes Minimum	Estimated Minutes Maximum
No. 1	10	45	55
No. 2	10	45	55
No. 3	10	45	55
No. 4	10	45	55
No. 5	10	40	50
Totals	50	220	270

INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

1. Record your 7-digit candidate number in the boxes provided at the upper right-hand corner of this page.

2. Question numbers 1, 2, 3, and 4 should be answered on the *Objective Answer Sheet,* which is pages 11 and 12 of your *Examination Answer Booklet.* You should attempt to answer all objective items. There is no penalty for incorrect responses. Work space to solve the objective questions is provided in this *Examination Question Booklet* on pages 3, 5, 7, 9, and 11. Be certain that you have entered your answers on the *Objective Answer Sheet* before the examination time is up. The objective portion of your examination will not be graded if you fail to record your answers on the *Objective Answer Sheet.* You will not be given additional time to record your answers.

3. Question number 5 should be answered on the worksheet on page 4 of the *Examination Answer Booklet.* Support your answer with properly labeled and legible calculations that can be identified as sources of amounts used to derive your final answer. If you have not completed answering question 5 on a page, fill in the appropriate spaces in the wording on the bottom of the page "**SUPPORTING CALCULATIONS CONTINUE ON PAGE ___.**" If you have completed answering question 5, fill in the appropriate space in the wording on the bottom of the page "**QUESTION NUMBER ___ ENDS ON THIS PAGE.**"

Record your 7-digit candidate number, state, and question number where indicated on pages 4 through 12.

4. *Additional ruled paper* is available if you need it. Additional pages should be numbered 10a, 10b, 10c, etc. If you used additional pages record the number of pages used on page 10, insert additional pages between pages 8 and 9, close the booklet, and staple. Do not staple booklet unless you used additional ruled paper.

5. Although the primary purpose of the examination is to test your knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.

6. You are required to turn in by the end of each session:

   a. Attendance Record Form, front page of Examination Answer Booklet;
   b. Objective Answer Sheet, pages 11 and 12 of Examination Answer Booklet;
   c. Remaining Portion of Examination Answer Booklet;
   d. Examination Question Booklet; and
   e. All unused examination materials.

   Your examination will not be graded unless the above listed items are handed in before leaving the examination room.

7. Unless otherwise instructed, if you want your *Examination Question Booklet* mailed to you, write your name and address in both places indicated on the back cover and place 52 cents postage in the space provided. Examination Question Booklets will be distributed no sooner than the day following the administration of this examination.

Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands of the United States.

Instructions

Questions Number 1, 2, and 3 each consist of 20 multiple-choice items. Select the **best answer for each** of the items. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of correct answers.

Number 1 (Estimated time —— 45 to 55 minutes)

Select the **best** answer for each of the following items relating to **the federal taxation of individuals, estates, and trusts. The answers should be based on the Internal Revenue Code and Tax Regulations in effect for the tax period specified in the item. If *no* tax period is specified, use the *current* Internal Revenue Code and Tax Regulations.**

Items 1 through 5 are based on the following:

Alex and Myra Burg, married and filing joint income tax returns, derive their entire income from the operation of their retail candy shop. Their 1991 adjusted gross income was $50,000. The Burgs itemized their deductions on Schedule A for 1991. The following unreimbursed cash expenditures were among those made by the Burgs during 1991:

Repair and maintenance of motorized wheelchair for physically handicapped dependent child	$ 300
Tuition, meals, and lodging at special school for physically handicapped dependent child in the institution primarily for the availability of medical care, with meals and lodging furnished as necessary incidents to that care	4,000
State income tax	1,200
Self-employment tax	7,650
Four tickets to a theatre party sponsored by a qualified charitable organization; not considered a business expense; similar tickets would cost $25 each at the box office	160
Repair of glass vase accidentally broken in home by dog; vase cost $500 in 1989; fair value $600 before accident and $200 after accident	90
Fee for breaking lease on prior apartment residence located 20 miles from new residence	500
Security deposit placed on apartment at new location	900

1. Without regard to the adjusted gross income percentage threshold, what amount may the Burgs claim in their 1991 return as qualifying medical expenses?
   A. $0
   B. $ 300
   C. $4,000
   D. $4,300

2. What amount should the Burgs deduct for taxes in their itemized deductions on Schedule A for 1991?
   A. $1,200
   B. $3,825
   C. $5,025
   D. $7,650

3. What amount should the Burgs deduct for gifts to charity in their itemized deductions on Schedule A for 1991?
   A. $160
   B. $100
   C. $ 60
   D. $0

4. Without regard to the $100 "floor" and the adjusted gross income percentage threshold, what amount should the Burgs deduct for the casualty loss in their itemized deductions on Schedule A for 1991?
   A. $0
   B. $ 90
   C. $300
   D. $400

5. What amount should the Burgs deduct for moving expenses in their itemized deductions on Schedule A for 1991?
   A. $0
   B. $ 500
   C. $ 900
   D. $1,400

---

6. On April 15, 1992, a married couple filed their joint 1991 calendar-year return showing gross income of $120,000. Their return had been prepared by a professional tax preparer who mistakenly omitted $45,000 of income, which the preparer in good faith considered to be nontaxable. No information with regard to this omitted income was disclosed on the return or attached statements. By what date must the Internal Revenue Service assert a notice of deficiency before the statute of limitations expires?
   A. April 15, 1998.
   B. December 31, 1997.
   C. April 15, 1995.
   D. December 31, 1994.

7. A claim for refund of erroneously paid income taxes, filed by an individual before the statute of limitations expires, must be submitted on Form
   A. 843
   B. 1040X
   C. 1045
   D. 1139

8. Ryan, age 57, is single with no dependents. In 1992, Ryan's principal residence was sold for the net amount of $400,000 after all selling expenses. Ryan bought the house in 1963 and occupied it until sold. On the date of sale, the house had a basis of $180,000. Ryan does not intend to buy another residence. What is the maximum exclusion of gain on sale of the residence that may be claimed in Ryan's 1992 income tax return?
   A. $220,000
   B. $125,000
   C. $ 62,500
   D. $0

9. Blake, a single individual age 67, had a 1991 adjusted gross income of $60,000 exclusive of social security benefits. Blake received social security benefits of $8,400 and interest of $1,000 on tax-exempt obligations during 1991. What amount of social security benefits is excludible from Blake's 1991 taxable income?
   A. $0
   B. $4,200
   C. $4,700
   D. $8,400

10. For head of household filing status, which of the following costs are considered in determining whether the taxpayer has contributed more than one-half the cost of maintaining the household?

	Food consumed in the home	*Value of services rendered in the home by the taxpayer*
A.	Yes	Yes
B.	No	No
C.	Yes	No
D.	No	Yes

11. To qualify for the child care credit on a joint return, at least one spouse must

	Have an adjusted gross income of $10,000 or less	*Be gainfully employed when related expenses are incurred*
A.	Yes	Yes
B.	No	No
C.	Yes	No
D.	No	Yes

MULTIPLE-CHOICE WORK SPACE

This information will **not** be graded. Only answers recorded on the Objective Answer Sheet will be graded.

12. A cash-basis taxpayer should report gross income
   - A. For the year in which income is either actually or constructively received, whether in cash or in property.
   - B. For the year in which income is either actually or constructively received in cash only.
   - C. Only for the year in which income is actually received whether in cash or in property.
   - D. Only for the year in which income is actually received in cash.

13. Unless the Internal Revenue Service consents to a change of method, the accrual method of tax reporting is mandatory for a sole proprietor when there are

	Accounts receivable for services rendered	*Year-end merchandise inventories*
A.	Yes	Yes
B.	Yes	No
C.	No	No
D.	No	Yes

14. Under a "cafeteria plan" maintained by an employer,
   - A. Participation must be restricted to employees, and their spouses and minor children.
   - B. At least three years of service are required before an employee can participate in the plan.
   - C. Participants may select their own menu of benefits.
   - D. Provision may be made for deferred compensation other than 401(k) plans.

15. Lee qualified as head of a household for 1991 tax purposes. Lee's 1991 taxable income was $100,000, exclusive of capital gains and losses. Lee had a net long-term loss of $8,000 in 1991. What amount of this capital loss can Lee offset against 1991 ordinary income?
   - A. $0
   - B. $3,000
   - C. $4,000
   - D. $8,000

16. Clark filed Form 1040EZ for the 1991 taxable year. In July 1992, Clark received a state income tax refund of $900, plus interest of $10, for overpayment of 1991 state income tax. What amount of the state tax refund and interest is taxable in Clark's 1992 federal income tax return?
   - A. $0
   - B. $ 10
   - C. $900
   - D. $910

17. Platt owns land that is operated as a parking lot. A shed was erected on the lot for the related transactions with customers. With regard to capital assets and Section 1231 assets, how should these assets be classified?

	Land	*Shed*
A.	Capital	Capital
B.	Section 1231	Capital
C.	Capital	Section 1231
D.	Section 1231	Section 1231

18. Among which of the following related parties are losses from sales and exchanges **not** recognized for tax purposes?
   - A. Father-in-law and son-in-law.
   - B. Brother-in-law and sister-in-law.
   - C. Grandfather and granddaughter.
   - D. Ancestors, lineal descendants, and all in-laws.

19. Feld, the sole stockholder of Maki Corp., paid $50,000 for Maki's stock in 1985. In 1991, Feld contributed a parcel of land to Maki but was not given any additional stock for this contribution. Feld's basis for the land was $10,000, and its fair market value was $18,000 on the date of the transfer of title. What is Feld's adjusted basis for the Maki stock?
   - A. $50,000
   - B. $52,000
   - C. $60,000
   - D. $68,000

20. Which of the following credits may be offset against the gross estate tax to determine the net estate tax of a U.S. citizen?

	Unified credit	*Credit for gift taxes paid on gifts made after 1976*
A.	Yes	Yes
B.	No	No
C.	No	Yes
D.	Yes	No

Number 2 (Estimated time —— 45 to 55 minutes)

Select the **best** answer for each of the following items relating to **a variety of managerial accounting problems.**

21. Yola Co. manufactures one product with a standard direct labor cost of four hours at $12.00 per hour. During June, 1,000 units were produced using 4,100 hours at $12.20 per hour. The unfavorable direct labor efficiency variance was
   - A. $1,220
   - B. $1,200
   - C. $ 820
   - D. $ 400

22. Sago Co. uses regression analysis to develop a model for predicting overhead costs. Two different cost drivers (machine hours and direct materials weight) are under consideration as the independent variable. Relevant data were run on a computer using one of the standard regression programs, with the following results:

	Coefficient
Machine hours	
Y Intercept	2,500
B	5.0
$R^2 = .70$	
Direct materials weight	
Y Intercept	4,600
B	2.6
$R^2 = .50$	

Which regression equation should be used?

A. Y=2,500+5.0X
B. Y=2,500+3.5X
C. Y=4,600+2.6X
D. Y=4,600+1.3X

23. Ral Co.'s target gross margin is 60% of the selling price of a product that costs $5.00 per unit. The product's selling price per unit should be

A. $17.50
B. $12.50
C. $ 8.33
D. $ 7.50

24. Carr Co. had an unfavorable materials usage variance of $900. What amounts of this variance should be charged to each department?

	Purchasing	*Warehousing*	*Manufacturing*
A.	$0	$0	$900
B.	$0	$900	$0
C.	$300	$300	$300
D.	$900	$0	$0

25. The following information pertains to Roe Co.'s 1991 manufacturing operations:

Standard direct labor hours per unit	2
Actual direct labor hours	10,500
Number of units produced	5,000
Standard variable overhead per standard direct labor hour	$3
Actual variable overhead	$28,000

Roe's 1991 unfavorable variable overhead efficiency variance was

A. $0
B. $1,500
C. $2,000
D. $3,500

MULTIPLE-CHOICE WORK SPACE

This information will **not** be graded. Only answers recorded on the Objective Answer Sheet will be graded.

26. In Belk Co.'s "just-in-time" production system, costs per set-up were reduced from $28 to $2. In the process of reducing inventory levels, Belk found that there were fixed facility and administrative costs that previously had not been included in the carrying cost calculation. The result was an increase from $8 to $32 per unit per year. What were the effects of these changes on Belk's economic lot size and relevant costs?

	Lot Size	*Relevant costs*
A.	Decrease	Increase
B.	Increase	Decrease
C.	Increase	Increase
D.	Decrease	Decrease

27. Spar Co. calculated the following ratios for one of its profit centers:

Gross margin	30%
Return on sales	25%
Capital turnover	.5 times

What is Spar's return on investment for this profit center?
A. 7.5%
B. 12.5%
C. 15.0%
D. 25.0%

28. Kim Co.'s profit center Zee had 1991 operating income of $200,000 before a $50,000 imputed interest charge for using Kim's assets. Kim's aggregate net income from all of its profit centers was $2,000,000. During 1991, Kim declared and paid dividends of $30,000 and $70,000 on its preferred and common stock, respectively. Zee's 1991 residual income was
A. $140,000
B. $143,000
C. $147,000
D. $150,000

29. Jones, a department manager, exercises control over the department's costs. Following is selected information relating to the department for July:

Variable factory overhead	
Budgeted based on standard hours allowed	$80,000
Actual	85,000
Fixed factory overhead	
Budgeted	25,000
Actual	27,000

The department's unfavorable spending variance for July was
A. $7,000
B. $5,000
C. $2,000
D. $0

30. Following are Mill Co.'s production costs for October:

Direct materials	$100,000
Direct labor	90,000
Factory overhead	4,000

What amount of costs should be traced to specific products in the production process?
A. $194,000
B. $190,000
C. $100,000
D. $ 90,000

31. In connection with a standard cost system being developed by Flint Co., the following information is being considered with regard to standard hours allowed for output of one unit of product:

	Hours
Average historical performance for the past three years	1.85
Production level to satisfy average consumer demand over a seasonal time span	1.60
Engineering estimates based on attainable performance	1.50
Engineering estimates based on ideal performance	1.25

To measure controllable production inefficiencies, what is the best basis for Flint to use in establishing standard hours allowed?
A. 1.25
B. 1.50
C. 1.60
D. 1.85

32. Mig Co., which began operations in 1991, produces gasoline and a gasoline by-product. The following information is available pertaining to 1991 sales and production:

Total production costs to split-off point		$120,000
Gasoline sales		270,000
By-product sales		30,000
Gasoline inventory, 12/31/91		15,000
Additional by-product costs:		
Marketing	10,000	
Production	15,000	

Mig accounts for the by-product at the time of production. What are Mig's 1991 cost of sales for gasoline and the by-product?

	Gasoline	*By-product*
A.	$105,000	$25,000
B.	$115,000	$0
C.	$108,000	$37,000
D.	$100,000	$0

33. Cay Co.'s 1991 fixed manufacturing overhead costs totaled $100,000, and variable selling costs totaled $80,000. Under direct costing, how should these costs be classified?

	Period costs	*Product costs*
A.	$0	$180,000
B.	$ 80,000	$100,000
C.	$100,000	$ 80,000
D.	$180,000	$0

34. Cook Co.'s total costs of operating five sales offices last year were $500,000, of which $70,000 represented fixed costs. Cook has determined that total costs are significantly influenced by the number of sales offices operated. Last year's costs and number of sales offices can be used as the bases for predicting annual costs. What would be the budgeted costs for the coming year if Cook were to operate seven sales offices?

A. $700,000
B. $672,000
C. $614,000
D. $586,000

35. Lon Co.'s budget committee is preparing its master budget on the basis of the following projections:

Sales	$2,800,000
Decrease in inventories	70,000
Decrease in accounts payable	150,000
Gross margin	40%

What are Lon's estimated cash disbursements for inventories?

A. $1,040,000
B. $1,200,000
C. $1,600,000
D. $1,760,000

36. The following information pertains to Syl Co.:

Sales	$800,000
Variable costs	160,000
Fixed costs	40,000

What is Syl's breakeven point in sales dollars?

A. $200,000
B. $160,000
C. $ 50,000
D. $ 40,000

37. Neu Co. is considering the purchase of an investment that has a positive net present value based on Neu's 12% hurdle rate. The internal rate of return would be

A. 0.
B. 12%.
C. > 12%.
D. < 12%.

MULTIPLE-CHOICE WORK SPACE

This information will **not** be graded. Only answers recorded on the Objective Answer Sheet will be graded.

38. Major Corp. is considering the purchase of a new machine for $5,000 that will have an estimated useful life of five years and no salvage value. The machine will increase Major's after-tax cash flow by $2,000 annually for five years. Major uses the straight-line method of depreciation and has an incremental borrowing rate of 10%. The present value factors for 10% are as follows:

Ordinary annuity with five payments	3.79
Annuity due for five payments	4.17

Using the payback method, how many years will it take to pay back Major's initial investment in the machine?
A. 2.50
B. 5.00
C. 7.58
D. 8.34

39. Lin Co. is buying machinery it expects will increase average annual operating income by $40,000. The initial increase in the required investment is $60,000, and the average increase in required investment is $30,000. To compute the accrual accounting rate of return, what amount should be used as the numerator in the ratio?
A. $20,000
B. $30,000
C. $40,000
D. $60,000

40. The following information pertains to Krel Co.'s computation of net present value relating to a contemplated project:

Discounted expected cash inflows	$1,000,000
Discounted expected cash outflows	700,000

Net present value is
A. $ 300,000
B. $ 700,000
C. $ 850,000
D. $1,000,000

Number 3 (Estimated time —— 45 to 55 minutes)

Select the **best** answer for each of the following items relating to **a variety of financial accounting problems.**

41. On May 18, 1992, Sol Corp.'s board of directors declared a 10% stock dividend. The market price of Sol's 3,000 outstanding shares of $2 par value common stock was $9 per share on that date. The stock dividend was distributed on July 21, 1992, when the stock's market price was $10 per share. What amount should Sol credit to additional paid-in capital for this stock dividend?
A. $2,100
B. $2,400
C. $2,700
D. $3,000

42. Cross Corp. had outstanding 2,000 shares of 11% preferred stock, $50 par. On August 8, 1992, Cross redeemed and retired 25% of these shares for $22,500. On that date, Cross' additional paid-in capital from preferred stock totaled $30,000. To record this transaction, Cross should debit (credit) its capital accounts as follows:

	Preferred stock	*Additional paid-in capital*	*Retained earnings*
A.	$25,000	$7,500	($10,000)
B.	$25,000	—	($ 2,500)
C.	$25,000	($2,500)	—
D.	$22,500	—	—

43. Boe Corp.'s stockholders' equity at December 31, 1991, was as follows:

6% noncumulative preferred stock, $100 par (liquidation value $105 per share)	$100,000
Common stock, $10 par	300,000
Retained earnings	95,000

At December 31, 1991, Boe's book value per common share was
A. $13.17
B. $13.00
C. $12.97
D. $12.80

44. On July 1, 1992, Cove Corp., a closely-held corporation, issued 6% bonds with a maturity value of $60,000, together with 1,000 shares of its $5 par value common stock, for a combined cash amount of $110,000. The market value of Cove's stock cannot be ascertained. If the bonds were issued separately, they would have sold for $40,000 on an 8% yield to maturity basis. What amount should Cove report for additional paid-in capital on the issuance of the stock?
A. $75,000
B. $65,000
C. $55,000
D. $45,000

45. Mio Corp. was the sole stockholder of Plasti Corp. On September 30, 1991, Mio declared a property dividend of Plasti's 2,000 outstanding shares of $1 par value common stock, distributable to Mio's stockholders. On that date, the book value of Plasti's stock was $1.50 per share. Immediately after the distribution, the market value of Plasti's stock was $4.50 per share. What amount should Mio report in its 1991 financial statements as gain on disposal of the Plasti stock?
A. $1,000
B. $2,000
C. $3,000
D. $6,000

46. On January 2, 1991, Air, Inc. agreed to pay its former president $300,000 under a deferred compensation arrangement. Air should have recorded this expense in 1990 but did not do so. Air's reported income tax expense would have been $70,000 lower in 1990 had it properly accrued this deferred compensation. In its December 31, 1991, financial statements, Air should adjust the beginning balance of its retained earnings by a

A. $230,000 credit.
B. $230,000 debit.
C. $300,000 credit.
D. $370,000 debit.

47. In September 1987, Cal Corp. made a dividend distribution of one right for each of its 240,000 shares of outstanding common stock. Each right was exercisable for the purchase of 1/100 of a share of Cal's $50 variable rate preferred stock at an exercise price of $80 per share. On March 20, 1992, none of the rights had been exercised, and Cal redeemed them by paying each stockholder $0.10 per right. As a result of this redemption, Cal's stockholders' equity was reduced by

A. $ 240
B. $ 4,800
C. $24,000
D. $72,000

Items 48 and 49 are based on the following:

Cor-Eng Partnership was formed on January 2, 1991. Under the partnership agreement, each partner has an equal initial capital balance accounted for under the goodwill method. Partnership net income or loss is allocated 60% to Cor and 40% to Eng. To form the partnership, Cor originally contributed assets costing $30,000 with a fair value of $60,000 on January 2, 1991, while Eng contributed $20,000 in cash. Drawings by the partners during 1991 totaled $3,000 by Cor and $9,000 by Eng. Cor-Eng's 1991 net income was $25,000.

48. Eng's initial capital balance in Cor-Eng is

A. $20,000
B. $25,000
C. $40,000
D. $60,000

49. Cor's share of Cor-Eng's 1991 net income is

A. $15,000
B. $12,500
C. $12,000
D. $ 7,800

MULTIPLE-CHOICE WORK SPACE

This information will **not** be graded. Only answers recorded on the Objective Answer Sheet will be graded.

50. On December 31, 1991, Pack Corp.'s board of directors canceled 50,000 shares of $2.50 par value common stock held in treasury at an average cost of $13 per share. Before recording the cancellation of the treasury stock, Pack had the following balances in its stockholder's equity accounts:

Common stock	$540,000
Additional paid-in capital	750,000
Retained earnings	900,000
Treasury stock, at cost	650,000

In its balance sheet at December 31, 1991, Pack should report common stock outstanding of
A. $0
B. $250,000
C. $415,000
D. $540,000

51. Brad Corp. has unconditional purchase obligations associated with product financing arrangements. These obligations are reported as liabilities on Brad's balance sheet, with the related assets also recognized. In the notes to Brad's financial statements, the aggregate amount of payments for these obligations should be disclosed for each of how many years following the date of the latest balance sheet?
A. 0
B. 1
C. 5
D. 10

52. On March 15, 1992, Krol Co. paid property taxes of $90,000 on its office building for the calendar year 1992. On April 1, 1992, Krol paid $150,000 for unanticipated repairs to its office equipment. The repairs will benefit operations for the remainder of 1992. What is the total amount of these expenses that Krol should include in its quarterly income statement for the three months ended June 30, 1992?
A. $172,500
B. $ 97,500
C. $ 72,500
D. $ 37,500

53. During January 1992, Haze Corp. won a litigation award for $15,000 which was tripled to $45,000 to include punitive damages. The defendant, who is financially stable, has appealed only the $30,000 punitive damages. Haze was awarded $50,000 in an unrelated suit it filed, which is being appealed by the defendant. Counsel is unable to estimate the outcome of these appeals. In its 1992 financial statements, Haze should report what amount of pretax gain?
A. $15,000
B. $45,000
C. $50,000
D. $95,000

Items 54 and 55 are based on the following:

Grum Corp., a publicly-owned corporation, is subject to the requirements for segment reporting. In its income statement for the year ended December 31, 1991, Grum reported revenues of $50,000,000, operating expenses of $47,000,000, and net income of $3,000,000. Operating expenses include payroll costs of $15,000,000. Grum's combined identifiable assets of all industry segments at December 31, 1991, were $40,000,000.

54. In its 1991 financial statements, Grum should disclose major customer data if sales to any single customer amount to at least
A. $ 300,000
B. $1,500,000
C. $4,000,000
D. $5,000,000

55. In its 1991 financial statements, Grum should disclose foreign operations data if revenues from foreign operations are at least
A. $5,000,000
B. $4,700,000
C. $4,000,000
D. $1,500,000

56. On June 1, 1991, Oak Corp. granted stock options to certain key employees as additional compensation. The options were for 1,000 shares of Oak's $2 par value common stock at an option price of $15 per share. Market price of this stock on June 1, 1991, was $20 per share. The options were exercisable beginning January 2, 1992, and expire on December 31, 1993. On April 1, 1992, when Oak's stock was trading at $21 per share, all the options were exercised. What amount of pretax compensation should Oak report in 1991 in connection with the options?
A. $6,000
B. $5,000
C. $2,500
D. $2,000

57. Clint owns 50% of Vohl Corp.'s common stock. Clint paid $20,000 for this stock in 1986. At December 31, 1991, Clint's 50% stock ownership in Vohl had a fair value of $180,000. Vohl's cumulative net income and cash dividends declared for the five years ended December 31, 1991, were $300,000 and $40,000, respectively. In Clint's personal statement of financial condition at December 31, 1991, what amount should be shown as the investment in Vohl?
A. $ 20,000
B. $150,000
C. $170,000
D. $180,000

58. Jen has been employed by Komp, Inc. since February 1, 1989. Jen is covered by Komp's Section 401(k) deferred compensation plan. Jen's contributions have been 10% of salaries. Komp has made matching contributions of 5%. Jen's salaries were $21,000 in 1989, $23,000 in 1990, and $26,000 in 1991. Employer contributions vest after an employee completes three years of continuous employment. The balance in Jen's 401(k) account was $11,900 at December 31, 1991, which included earnings of $1,200 on Jen's contributions. What amount should be reported for Jen's vested interest in the 401(k) plan in Jen's December 31, 1991, personal statement of financial condition?

A. $11,900
B. $ 8,200
C. $ 7,000
D. $ 1,200

59. The following information pertains to an insurance policy that Barton owns on his life:

Face amount	$100,000
Accumulated premiums paid up to December 31, 1991	8,000
Cash value at December 31, 1991	12,000
Policy loan	3,000

In Barton's personal statement of financial condition at December 31, 1991, what amount should be reported for the investment in life insurance?

A. $97,000
B. $12,000
C. $ 9,000
D. $ 8,000

60. The following information pertains to shipments of merchandise from Home Office to Branch during 1991:

Home Office's cost of merchandise	$160,000
Intracompany billing	200,000
Sales by Branch	250,000
Unsold merchandise at Branch on December 31, 1991	20,000

In the combined income statement of Home Office and Branch for the year ended December 31, 1991, what amount of the above transactions should be included in sales?

A. $250,000
B. $230,000
C. $200,000
D. $180,000

MULTIPLE-CHOICE WORK SPACE

This information will **not** be graded. Only answers recorded on the Objective Answer Sheet will be graded.

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Number 4 (Estimated time —— 45 to 55 minutes)

Instructions

Question Number 4 consists of 20 items relating to a municipal government. Select the **best** answer for each item. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Answer all items.** Your grade will be based on the total number of correct answers.

Items 61 through 70, in the left-hand column represent various transactions pertaining to a municipality that uses encumbrance accounting. To the right of these items is a listing of possible ways to record the transactions. Items 71 through 80, also listed in the left-hand column, represent the funds, accounts, and account groups used by the municipality. To the right of these items is a list of possible accounting and reporting methods.

Required:

a. For each of the municipality's transactions (Items 61 through 70), select the appropriate recording of the transaction and blacken the corresponding oval on the Objective Answer Sheet. A method of recording the transactions may be selected once, more than once, or not at all.

b. For each of the municipality's funds, accounts, and account groups (Items 71 through 80), select the appropriate method of accounting and reporting and blacken the corresponding oval on the Objective Answer Sheet. An accounting and reporting method may be selected once, more than once, or not at all.

Example:

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

Item Transactions		Recording of Transactions
99. Payment of a previously recorded voucher.		D. Debit vouchers payable.

Answer Sheet

Item	Recording of Transactions (select one)
99	Ⓐ Ⓑ Ⓒ ● Ⓔ Ⓕ Ⓖ Ⓗ Ⓘ Ⓙ Ⓚ Ⓛ

Number 4 (continued)

Items to be Answered:

a. Transactions

61. General obligation bonds were issued at par.
62. Approved purchase orders were issued for supplies.
63. The above-mentioned supplies were received and the related invoices were approved.
64. General fund salaries and wages were incurred.
65. The internal service fund had interfund billings.
66. Revenues were earned from a previously awarded grant.
67. Property taxes were collected in advance.
68. Appropriations were recorded on adoption of the budget.
69. Short-term financing was received from a bank, secured by the city's taxing power.
70. There was an excess of estimated inflows over estimated outflows.

Recording of Transactions

A. Credit appropriations control.
B. Credit budgetary fund balance — unreserved.
C. Credit expenditures control.
D. Credit deferred revenues.
E. Credit interfund revenues.
F. Credit tax anticipation notes payable.
G. Credit other financing sources.
H. Credit other financing uses.
I. Debit appropriations control.
J. Debit deferred revenues.
K. Debit encumbrances control.
L. Debit expenditures control.

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b. Funds, Accounts, and Account Groups

71. Enterprise fund fixed assets.
72. Capital projects fund.
73. General fixed assets.
74. Infrastructure fixed assets.
75. Enterprise fund cash.
76. General fund.
77. Agency fund cash.
78. General long-term debt.
79. Special revenue fund.
80. Debt services fund.

Accounting and Reporting by Funds and Account Groups

A. Accounted for in a fiduciary fund.
B. Accounted for in a proprietary fund.
C. Accounted for in a quasi-endowment fund.
D. Accounted for in a self-balancing account group.
E. Accounted for in a special assessment fund.
F. Accounts for major construction activities.
G. Accounts for property tax revenues.
H. Accounts for payment of interest and principal on tax supported debt.
I. Accounts for revenues from earmarked sources to finance designated activities.
J. Reporting is optional.

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

On January 2, 1991, Dali and Conti established and started operating Perle Restaurant, in which both actively participate as equal partners. Perle's income statement for the year ended December 31, 1991, is presented below and on page 4 of the Examination Answer Booklet.

Sales			$900,000
Cost of sales			360,000
Gross profit			540,000
Operating expenses:			
Salaries and wages (excluding partners)	$179,000		
Less jobs credit	9,000	$170,000	
Guaranteed payments to partners		100,000	
Amortization of permanent liquor license		1,000	
Annual liquor license fee		500	
Depreciation		26,000	
Partners' health insurance premiums		8,000	
Contributions to defined benefit (Keogh) pension plan		12,500	
Charitable contribution		50,000	368,000
Operating (ordinary) income			172,000
Other income (loss):			
Dividends		1,600	
Rental		(300)	
Total		1,300	
Other expense:			
Interest on investment debt		(800)	500
Total income			$172,500

Additional information:

- Dali and Conti share profits and losses equally.
- The jobs credit pertains to qualified wages paid to an approved target group.
- Guaranteed payments to partners are for services rendered and are determined without regard to partnership income.
- In addition to the guaranteed payments, Dali and Conti each drew $29,000. These drawings were unrelated to the guaranteed payments.
- The permanent liquor license was purchased for $5,000 from a cafe that had gone out of business. This license, which is renewable for an indefinite period, is being amortized over the 5-year term of Perle's lease.
- The cost of depreciable personal property used in the restaurant operations was $200,000. Perle elected to expense the maximum amount allowable for these Section 179 assets. The $26,000 depreciation includes the Section 179 deduction.
- The health insurance premiums were paid for services rendered by the partners without regard to partnership income. The value of the premiums to the partners equaled the cost of this coverage.
- Guaranteed payments to partners and partners' health insurance premiums are divided equally between Dali and Conti.
- Of the $12,500 contributions to the defined benefit (Keogh) pension plan, $7,000 was paid on behalf of the partners.
- The $50,000 charitable contribution is the adjusted basis of stock that had been bought as an investment. Its fair market value was $53,000 when it was donated to a qualified charitable organization.
- Perle sustained a $300 net loss on the rental of a vacant lot unrelated to the restaurant operations.

Required:
Complete the worksheet on page 31 of the Examination Answer Booklet to show the adjusted amounts that should appear for:

Perle's Income and Deductions on page 1 of Form 1065, Partnership Return.

Perle's Schedule K, Partners' Shares of Income, Credits, Deductions, Etc.

Dali's Schedule K-1, Partner's Share of Income, Credits, Deductions, Etc.

ACCOUNTING PRACTICE — PART II

Question Number 5

Record your 7-digit candidate number in the boxes. → **CANDIDATE NUMBER**

State ______

Page ______

Dali and Conti, D/B/A
Perle Restaurant
TAX WORKSHEET
For the Year Ended December 31, 1991

	Income Statement	*Adjustments*	*Perle's Income & Deductions*	*Information for Perle's Schedule K*	*Information for Dali's Schedule K-1*
Sales	900,000				
Cost of Sales	360,000				
Gross profit	540,000				
Operating expenses:					
Salaries and wages (excluding partners)	179,000				
Less jobs credit	(9,000)				
Guaranteed payments to partners	100,000				
Amortization of permanent liquor license	1,000				
Annual liquor license fee	500				
Depreciation	26,000				
Section 179 expense deduction					
Partners' health insurance premiums	8,000				
Keogh contributions	12,500				
Charitable contribution	50,000				
Total operating expenses	368,000				
Operating (ordinary) income	172,000				
Other income (loss):					
Dividends	1,600				
Rental	(300)				
Other expense:					
Interest on investment debt	(800)				
Total income	172,500				

SUPPORTING CALCULATIONS CONTINUE ON PAGE ___. / or QUESTION NUMBER ___ ENDS ON THIS PAGE.

PLEASE DO NOT MARK IN THIS AREA

SERIAL NO.

AUDITING

November 5, 1992; 8:30 A.M. to 12:00 Noon

Q-A

CANDIDATE NUMBER

Record your 7-digit candidate number in the boxes.

The point values for each question, and estimated time allotments based primarily on point value, are as follows:

	Point Value	Estimated Minutes Minimum	Estimated Minutes Maximum
No. 1	60	90	110
No. 2	10	15	25
No. 3	10	15	25
No. 4	10	15	25
No. 5	10	15	25
Totals	100	150	210

INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

1. Record your 7-digit candidate number in the boxes provided at the upper right-hand corner of this page.

2. Question numbers 1 and 2 should be answered on the *Objective Answer Sheet,* which is pages 15 and 16 of your *Examination Answer Booklet*. You should attempt to answer all objective items. There is no penalty for incorrect responses. Since the objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the *Objective Answer Sheet* before the examination time is up. The objective portion of your examination will not be graded if you fail to record your answers on the *Objective Answer Sheet*. You will not be given additional time to record your answers.

3. Question numbers 3, 4, and 5 should be answered beginning on page 3 of the *Examination Answer Booklet*. If you have not completed answering a question on a page, fill in the appropriate spaces in the wording on the bottom of the page "**QUESTION NUMBER __ CONTINUES ON PAGE __.**" If you have completed answering a question, fill in the appropriate space in the wording on the bottom of the page "**QUESTION NUMBER __ ENDS ON THIS PAGE.**" Always begin the start of an answer to a question on the top of a new page.

   Record your 7-digit candidate number, state, and question number where indicated on pages 3 through 14.

4. *Additional ruled paper* is available if you need it. Additional pages should be numbered 14a, 14b, 14c, etc. If you used additional pages record the number of pages used on page 14, insert additional pages between pages 12 and 13, close the booklet, and staple. Do not staple booklet unless you used additional ruled paper.

5. Although the primary purpose of the examination is to test your knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.

6. You are required to turn in by the end of each session:

   a. Attendance Record Form, front page of Examination Answer Booklet;
   b. Objective Answer Sheet, pages 15 and 16 of Examination Answer Booklet;
   c. Remaining Portion of Examination Answer Booklet;
   d. Examination Question Booklet; and
   e. All unused examination materials.

   Your examination will not be graded unless the above listed items are handed in before leaving the examination room.

7. Unless otherwise instructed, if you want your *Examination Question Booklet* mailed to you, write your name and address in both places indicated on the back cover and place 52 cents postage in the space provided. Examination Question Booklets will be distributed no sooner than the day following the administration of this examination.

Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands of the United States.

Number 1 (Estimated time —— 90 to 110 minutes)

Instructions

Select the **best** answer for each of the following items. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of correct answers.

1. To exercise due professional care an auditor should
   A. Attain the proper balance of professional experience and formal education.
   B. Design the audit to detect all instances of illegal acts.
   C. Critically review the judgment exercised by those assisting in the audit.
   D. Examine all available corroborating evidence supporting management's assertions.

2. In which of the following situations would a CPA's independence be considered to be impaired?

   I. The CPA maintains a checking account that is fully insured by a government deposit insurance agency at an audit-client financial institution.
   II. The CPA has a direct financial interest in an audit client, but the interest is maintained in a blind trust.
   III. The CPA owns a commercial building and leases it to an audit client. The rental income is material to the CPA.

   A. I and II.
   B. II and III.
   C. I and III.
   D. I, II, and III.

3. One of a CPA firm's basic objectives is to provide professional services that conform with professional standards. Reasonable assurance of achieving this basic objective is provided through
   A. A system of quality control.
   B. A system of peer review.
   C. Continuing professional education.
   D. Compliance with generally accepted reporting standards.

4. When an auditor becomes aware of a possible illegal act by a client, the auditor should obtain an understanding of the nature of the act to
   A. Evaluate the effect on the financial statements.
   B. Determine the reliability of management's representations.
   C. Consider whether other similar acts may have occurred.
   D. Recommend remedial actions to the audit committee.

5. Which of the following accounting services may an accountant perform **without** being required to issue a compilation or review report under the Statements on Standards for Accounting and Review Services?

   I. Preparing a working trial balance.
   II. Preparing standard monthly journal entries.

   A. I only.
   B. II only.
   C. Both I and II.
   D. Neither I nor II.

6. When assessing an internal auditor's objectivity, an independent auditor should
   A. Evaluate the adequacy of the internal auditor's audit programs.
   B. Inquire about the internal auditor's educational background and professional certification.
   C. Consider the organizational level to which the internal auditor reports.
   D. Review the internal auditor's working papers.

7. When considering the internal control structure, an auditor should be aware of the concept of reasonable assurance, which recognizes that
   A. Procedures requiring segregation of duties may be circumvented by employee collusion and management override.
   B. Establishing and maintaining the internal control structure is an important responsibility of management.
   C. The cost of an entity's internal control structure should **not** exceed the benefits expected to be derived.
   D. Adequate safeguards over access to assets and records should permit an entity to maintain proper accountability.

8. The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that
   A. Specified controls requiring segregation of duties may be circumvented by collusion.
   B. Entity policies may be overridden by senior management.
   C. Tests of controls may fail to identify procedures relevant to assertions.
   D. Material misstatements may exist in the financial statements.

9. An auditor's primary consideration regarding an entity's internal control structure policies and procedures is whether the policies and procedures
   A. Affect the financial statement assertions.
   B. Prevent management override.
   C. Relate to the control environment.
   D. Reflect management's philosophy and operating style.

10. As the acceptable level of detection risk increases, an auditor may change the
   A. Assessed level of control risk from below the maximum to the maximum level.
   B. Assurance provided by tests of controls by using a larger sample size than planned.
   C. Timing of substantive tests from year end to an interim date.
   D. Nature of substantive tests from a less effective to a more effective procedure.

11. Which of the following types of evidence would an auditor most likely examine to determine whether internal control structure policies and procedures are operating as designed?
   A. Confirmations of receivables verifying account balances.
   B. Letters of representations corroborating inventory pricing.
   C. Attorneys' responses to the auditor's inquiries.
   D. Client records documenting the use of EDP programs.

12. An online sales order processing system most likely would have an advantage over a batch sales order processing system by
   A. Detecting errors in the data entry process more easily by the use of edit programs.
   B. Enabling shipment of customer orders to be initiated as soon as the orders are received.
   C. Recording more secure backup copies of the data base on magnetic tape files.
   D. Maintaining more accurate records of customer accounts and finished goods inventories.

13. Which of the following controls most likely would help ensure that all credit sales transactions of an entity are recorded?
   A. The billing department supervisor sends copies of approved sales orders to the credit department for comparison to authorized credit limits and current customer account balances.
   B. The accounting department supervisor independently reconciles the accounts receivable subsidiary ledger to the accounts receivable control account monthly.
   C. The accounting department supervisor controls the mailing of monthly statements to customers and investigates any differences reported by customers.
   D. The billing department supervisor matches prenumbered shipping documents with entries in the sales journal.

14. An entity with a large volume of customer remittances by mail could most likely reduce the risk of employee misappropriation of cash by using
   A. Employee fidelity bonds.
   B. Independently prepared mailroom prelists.
   C. Daily check summaries.
   D. A bank lockbox system.

15. For effective internal control, the accounts payable department generally should
   A. Obliterate the quantity ordered on the receiving department copy of the purchase order.
   B. Establish the agreement of the vendor's invoice with the receiving report and purchase order.
   C. Stamp, perforate, or otherwise cancel supporting documentation after payment is mailed.
   D. Ascertain that each requisition is approved as to price, quantity, and quality by an authorized employee.

16. When the shipping department returns nonconforming goods to a vendor, the purchasing department should send to the accounting department the
   A. Unpaid voucher.
   B. Debit memo.
   C. Vendor invoice.
   D. Credit memo.

17. An entity's internal control structure requires for every check request that there be an approved voucher, supported by a prenumbered purchase order and a prenumbered receiving report. To determine whether checks are being issued for unauthorized expenditures, an auditor most likely would select items for testing from the population of all
   A. Purchase orders.
   B. Canceled checks.
   C. Receiving reports.
   D. Approved vouchers.

18. When there are numerous property and equipment transactions during the year, an auditor who plans to assess control risk at a low level usually performs
   A. Analytical procedures for property and equipment balances at the end of the year.
   B. Tests of controls and extensive tests of property and equipment balances at the end of the year.
   C. Analytical procedures for current year property and equipment transactions.
   D. Tests of controls and limited tests of current year property and equipment transactions.

19. In obtaining an understanding of a manufacturing entity's internal control structure concerning inventory balances, an auditor most likely would
   A. Review the entity's descriptions of inventory policies and procedures.
   B. Perform test counts of inventory during the entity's physical count.
   C. Analyze inventory turnover statistics to identify slow-moving and obsolete items.
   D. Analyze monthly production reports to identify variances and unusual transactions.

20. If a control total were computed on each of the following data items, which would best be identified as a hash total for a payroll EDP application?
   A. Total debits and total credits.
   B. Net pay.
   C. Department numbers.
   D. Hours worked.

21. Which of the following procedures most likely would be considered a weakness in an entity's internal controls over payroll?
   A. A voucher for the amount of the payroll is prepared in the general accounting department based on the payroll department's payroll summary.
   B. Payroll checks are prepared by the payroll department and signed by the treasurer.
   C. The employee who distributes payroll checks returns unclaimed payroll checks to the payroll department.
   D. The personnel department sends employees' termination notices to the payroll department.

22. Which of the following controls would an entity most likely use in safeguarding against the loss of marketable securities?
   A. An independent trust company that has **no** direct contact with the employees who have record keeping responsibilities has possession of the securities.
   B. The internal auditor verifies the marketable securities in the entity's safe each year on the balance sheet date.
   C. The independent auditor traces all purchases and sales of marketable securities through the subsidiary ledgers to the general ledger.
   D. A designated member of the board of directors controls the securities in a bank safe-deposit box.

23. Which of the following representations should **not** be included in a report on internal control structure related matters noted in an audit?
   A. Reportable conditions related to the internal control structure design exist, but **none** is deemed to be a material weakness.
   B. There are **no** significant deficiencies in the design or operation of the internal control structure.
   C. Corrective follow-up action is recommended due to the relative significance of material weaknesses discovered during the audit.
   D. The auditor's consideration of the internal control structure would **not** necessarily disclose all reportable conditions that exist.

24. When reporting on an entity's internal control structure under *Government Auditing Standards*, an auditor should issue a written report that includes a
    A. Statement of negative assurance that nothing came to the auditor's attention that caused the auditor to believe reportable conditions were present.
    B. Statement of positive assurance that the results of tests indicate that the internal control structure either can, or cannot, be relied on to reduce control risk to an acceptable level.
    C. Description of the weaknesses considered to be reportable conditions and the strengths that the auditor can rely on in reducing the extent of substantive testing.
    D. Description of the scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing control risk.

25. In planning a statistical sample for a test of controls, an auditor increased the expected population deviation rate from the prior year's rate because of the results of the prior year's tests of controls and the overall control environment. The auditor most likely would then increase the planned
    A. Tolerable rate.
    B. Allowance for sampling risk.
    C. Risk of assessing control risk too low.
    D. Sample size.

26. Which of the following types of audit evidence is the **least** persuasive?
    A. Prenumbered purchase order forms.
    B. Bank statements obtained from the client.
    C. Test counts of inventory performed by the auditor.
    D. Correspondence from the client's attorney about litigation.

27. Which of the following combinations of procedures would an auditor most likely perform to obtain evidence about fixed asset additions?
    A. Inspecting documents and physically examining assets.
    B. Recomputing calculations and obtaining written management representations.
    C. Observing operating activities and comparing balances to prior period balances.
    D. Confirming ownership and corroborating transactions through inquiries of client personnel.

28. An auditor most likely would inspect loan agreements under which an entity's inventories are pledged to support management's financial statement assertion of
    A. Existence or occurrence.
    B. Completeness.
    C. Presentation and disclosure.
    D. Valuation or allocation.

29. An auditor most likely would analyze inventory turnover rates to obtain evidence concerning management's assertions about
    A. Existence or occurrence.
    B. Rights and obligations.
    C. Presentation and disclosure.
    D. Valuation or allocation.

30. Which of the following procedures would an auditor most likely perform to verify management's assertion of completeness?
    A. Compare a sample of shipping documents to related sales invoices.
    B. Observe the client's distribution of payroll checks.
    C. Confirm a sample of recorded receivables by direct communication with the debtors.
    D. Review standard bank confirmations for indications of kiting.

31. An auditor's decision either to apply analytical procedures as substantive tests or to perform tests of transactions and account balances usually is determined by the
    A. Availability of data aggregated at a high level.
    B. Relative effectiveness and efficiency of the tests.
    C. Timing of tests performed after the balance sheet date.
    D. Auditor's familiarity with industry trends.

32. Analytical procedures used in the overall review stage of an audit generally include
    A. Considering unusual or unexpected account balances that were **not** previously identified.
    B. Performing tests of transactions to corroborate management's financial statement assertions.
    C. Gathering evidence concerning account balances that have **not** changed from the prior year.
    D. Retesting control procedures that appeared to be ineffective during the assessment of control risk.

33. In using the work of a specialist, an understanding should exist among the auditor, the client, and the specialist as to the nature of the specialist's work. The documentation of this understanding should cover
    A. A statement that the specialist assumes **no** responsibility to update the specialist's report for future events or circumstances.
    B. The conditions under which a division of responsibility may be necessary.
    C. The specialist's understanding of the auditor's corroborative use of the specialist's findings.
    D. The auditor's disclaimer as to whether the specialist's findings corroborate the representations in the financial statements.

34. To which of the following matters would materiality limits **not** apply when obtaining written client representations?
    A. Losses from sales commitments.
    B. Unasserted claims and assessments.
    C. Irregularities involving management.
    D. Noncompliance with contractual agreements.

35. Which of the following factors most likely would affect an auditor's judgment about the quantity, type, and content of the auditor's working papers?
    A. The assessed level of control risk.
    B. The likelihood of a review by a concurring (second) partner.
    C. The number of personnel assigned to the audit.
    D. The content of the management representation letter.

36. Processing data through the use of simulated files provides an auditor with information about the operating effectiveness of control policies and procedures. One of the techniques involved in this approach makes use of
    A. Controlled reprocessing.
    B. An integrated test facility.
    C. Input validation.
    D. Program code checking.

37. An auditor most likely would test for the presence of unauthorized EDP program changes by running a
    A. Program with test data.
    B. Check digit verification program.
    C. Source code comparison program.
    D. Program that computes control totals.

38. An auditor may decide to increase the risk of incorrect rejection when
    A. Increased reliability from the sample is desired.
    B. Many differences (audit value minus recorded value) are expected.
    C. Initial sample results do **not** support the planned level of control risk.
    D. The cost and effort of selecting additional sample items is low.

39. Which of the following courses of action would an auditor most likely follow in planning a sample of cash disbursements if the auditor is aware of several unusually large cash disbursements?
    A. Increase the sample size to reduce the effect of the unusually large disbursements.
    B. Continue to draw new samples until all the unusually large disbursements appear in the sample.
    C. Set the tolerable rate of deviation at a lower level than originally planned.
    D. Stratify the cash disbursements population so that the unusually large disbursements are selected.

40. Which of the following most likely would indicate the existence of related parties?
    A. Writing down obsolete inventory just before year end.
    B. Failing to correct previously identified internal control structure deficiencies.
    C. Depending on a single product for the success of the entity.
    D. Borrowing money at an interest rate significantly below the market rate.

41. Which of the following procedures would an auditor most likely perform to obtain evidence about the occurrence of subsequent events?
    A. Recomputing a sample of large-dollar transactions occurring after year end for arithmetic accuracy.
    B. Investigating changes in stockholders' equity occurring after year end.
    C. Inquiring of the entity's legal counsel concerning litigation, claims, and assessments arising after year end.
    D. Confirming bank accounts established after year end.

42. The concept of materiality for financial statements audited under the Single Audit Act of 1984 differs from materiality in an audit in accordance with generally accepted auditing standards. Under the Act, materiality is
   A. Determined by the federal agency requiring the audit.
   B. Ignored, because all account balances, regardless of size, are fully tested.
   C. Determined separately for each major federal financial assistance program.
   D. Calculated without consideration of the auditor's risk assessment.

43. Which of the following inquiry or analytical procedures ordinarily is performed in an engagement to review a nonpublic entity's financial statements?
   A. Analytical procedures designed to test the accounting records by obtaining corroborating evidential matter.
   B. Inquiries concerning the entity's procedures for recording and summarizing transactions.
   C. Analytical procedures designed to test management's assertions regarding continued existence.
   D. Inquiries of the entity's attorney concerning contingent liabilities.

44. When compiling the financial statements of a nonpublic entity, an accountant should
   A. Review agreements with financial institutions for restrictions on cash balances.
   B. Understand the accounting principles and practices of the entity's industry.
   C. Inquire of key personnel concerning related parties and subsequent events.
   D. Perform ratio analyses of the financial data of comparable prior periods.

45. Which of the following procedures is **not** usually performed by the accountant during a review engagement of a nonpublic entity?
   A. Inquiring about actions taken at meetings of the board of directors that may affect the financial statements.
   B. Issuing a report stating that the review was performed in accordance with standards established by the AICPA .
   C. Reading the financial statements to consider whether they conform with generally accepted accounting principles.
   D. Communicating any material weaknesses discovered during the consideration of the internal control structure.

46. Which of the following phrases should be included in the opinion paragraph when an auditor expresses a qualified opinion?

	When read in conjunction with Note X	*With the foregoing explanation*
A.	Yes	No
B.	No	Yes
C.	Yes	Yes
D.	No	No

47. When an auditor expresses an adverse opinion, the opinion paragraph should include
   A. The principal effects of the departure from generally accepted accounting principles.
   B. A direct reference to a separate paragraph disclosing the basis for the opinion.
   C. The substantive reasons for the financial statements being misleading.
   D. A description of the uncertainty or scope limitation that prevents an unqualified opinion.

48. Under which of the following circumstances would a disclaimer of opinion **not** be appropriate?
   A. The financial statements fail to contain adequate disclosure of related party transactions.
   B. The client refuses to permit its attorney to furnish information requested in a letter of audit inquiry.
   C. The auditor is engaged after fiscal year-end and is unable to observe physical inventories or apply alternative procedures to verify their balances.
   D. The auditor is unable to determine the amounts associated with illegal acts committed by the client's management.

49. Green, CPA, concludes that there is substantial doubt about JKL Co.'s ability to continue as a going concern. If JKL's financial statements adequately disclose its financial difficulties, Green's auditor's report should

	Include an explanatory paragraph following the opinion paragraph	*Specifically use the words "going concern"*	*Specifically use the words "substantial doubt"*
A.	Yes	Yes	Yes
B.	Yes	Yes	No
C.	Yes	No	Yes
D.	No	Yes	Yes

50. Blue, CPA, has been asked to render an opinion on the application of accounting principles to a specific transaction by an entity that is audited by another CPA. Blue may accept this engagement, but should
   A. Consult with the continuing CPA to obtain information relevant to the transaction.
   B. Report the engagement's findings to the entity's audit committee, the continuing CPA, and management.
   C. Disclaim any opinion that the hypothetical application of accounting principles conforms with generally accepted accounting principles.
   D. Notify the entity that the report is for the restricted use of management and outside parties who are aware of all relevant facts.

51. Which of the following procedures ordinarily should be applied when an independent accountant conducts a review of interim financial information of a publicly held entity?
   A. Verify changes in key account balances.
   B. Read the minutes of the board of directors' meetings.
   C. Inspect the open purchase order file.
   D. Perform cut-off tests for cash receipts and disbursements.

52. Jones Retailing, a nonpublic entity, has asked Winters, CPA, to compile financial statements that omit substantially all disclosures required by generally accepted accounting principles. Winters may compile such financial statements provided the
   A. Reason for omitting the disclosures is explained in the engagement letter and acknowledged in the management representation letter.
   B. Financial statements are prepared on a comprehensive basis of accounting other than generally accepted accounting principles.
   C. Distribution of the financial statements is restricted to internal use only.
   D. Omission is **not** undertaken to mislead the users of the financial statements and is properly disclosed in the accountant's report.

53. The standard report issued by an accountant after reviewing the financial statements of a nonpublic entity states that
   A. A review includes assessing the accounting principles used and significant estimates made by management.
   B. A review includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
   C. The accountant is **not** aware of any material modifications that should be made to the financial statements.
   D. The accountant does **not** express an opinion or any other form of assurance on the financial statements.

54. An auditor's special report on financial statements prepared in conformity with the cash basis of accounting should include a separate explanatory paragraph before the opinion paragraph that
   A. Justifies the reasons for departing from generally accepted accounting principles.
   B. States whether the financial statements are fairly presented in conformity with another comprehensive basis of accounting.
   C. Refers to the note to the financial statements that describes the basis of accounting.
   D. Explains how the results of operations differ from financial statements prepared in conformity with generally accepted accounting principles.

55. An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that
   A. The prospective financial statements are also examined.
   B. Responsibility for the adequacy of the procedures performed is taken by the accountant.
   C. Negative assurance is expressed on the prospective financial statements taken as a whole.
   D. Distribution of the report is restricted to the specified users.

56. Hill, CPA, is auditing the financial statements of Helping Hand, a not-for-profit organization that receives financial assistance from governmental agencies. To detect misstatements in Helping Hand's financial statements resulting from violations of laws and regulations, Hill should focus on violations that
   A. Could result in criminal prosecution against the organization.
   B. Involve reportable conditions to be communicated to the organization's trustees and the funding agencies.
   C. Have a direct and material effect on the amounts in the organization's financial statements.
   D. Demonstrate the existence of material weaknesses in the organization's internal control structure.

57. When audited financial statements are presented in a client's document containing other information, the auditor should

A. Perform inquiry and analytical procedures to ascertain whether the other information is reasonable.
B. Add an explanatory paragraph to the auditor's report without changing the opinion on the financial statements.
C. Perform the appropriate substantive auditing procedures to corroborate the other information.
D. Read the other information to determine that it is consistent with the audited financial statements.

58. Comfort letters ordinarily are signed by the client's

A. Independent auditor.
B. Underwriter of securities.
C. Audit committee.
D. Senior management.

59. An auditor's report contains the following sentences:

We did not audit the financial statements of JK Co., a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 17 percent and 19 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for JK Co., is based solely on the report of the other auditors.

These sentences

A. Are an improper form of reporting.
B. Divide responsibility.
C. Disclaim an opinion.
D. Qualify the opinion.

60. Which of the following matters is an auditor required to communicate to an entity's audit committee?

I. Disagreements with management about matters significant to the entity's financial statements that have been satisfactorily resolved.
II. Initial selection of significant accounting policies in emerging areas that lack authoritative guidance.

A. I only.
B. II only.
C. Both I and II.
D. Neither I nor II.

Question Number 2 Begins on Page 42

This page intentionally left blank.

Number 2 (Estimated time —— 15 to 25 minutes)

Instructions:

Question Number 2 consists of 10 items. Select the **best** answer for each item. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Answer all items.** Your grade will be based on the total number of correct answers.

To support financial statement assertions, an auditor develops specific audit objectives. The auditor then designs substantive tests to satisfy or accomplish each objective.

Required:

Items 61 through 70 represent audit objectives for the investments, accounts receivable, and property and equipment accounts. To the right of each set of audit objectives is a listing of possible audit procedures for that account. For each audit objective, select the audit procedure that would primarily respond to the objective and blacken the corresponding oval on the Objective Answer Sheet. Select only one procedure for each audit objective. A procedure may be selected only once, or not at all.

Example:

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

Item

Audit Objectives for Cash	Audit Procedures for Cash
99. Recorded cash represents cash on hand at the balance sheet date.	C. Count cash on hand.

Answer Sheet

Item	Audit Procedures (select one per item)
99	Ⓐ Ⓑ ● Ⓓ Ⓔ Ⓕ Ⓖ

Items to be Answered:

Audit Objectives for Investments

61. Investments are properly described and classified in the financial statements.

62. Recorded investments represent investments actually owned at the balance sheet date.

63. Investments are properly valued at the lower of cost or market at the balance sheet date.

Audit Procedures for Investments

A. Trace opening balances in the subsidiary ledger to prior year's audit working papers.

B. Determine that employees who are authorized to sell investments do not have access to cash.

C. Examine supporting documents for a sample of investment transactions to verify that prenumbered documents are used.

D. Determine that any impairments in the price of investments have been properly recorded.

E. Verify that transfers from the current to the noncurrent investment portfolio have been properly recorded.

F. Obtain positive confirmations as of the balance sheet date of investments held by independent custodians.

G. Trace investment transactions to minutes of the Board of Directors meetings to determine that transactions were properly authorized.

Number 2 (continued)

Audit Objectives for Accounts Receivable

64. Accounts receivable represent all amounts owed to the entity at the balance sheet date.

65. The entity has legal right to all accounts receivable at the balance sheet date.

66. Accounts receivable are stated at net realizable value.

67. Accounts receivable are properly described and presented in the financial statements.

Audit Procedures for Accounts Receivable

A. Analyze the relationship of accounts receivable and sales and compare it with relationships for preceding periods.

B. Perform sales cut-off tests to obtain assurance that sales transactions and corresponding entries for inventories and cost of goods sold are recorded in the same and proper period.

C. Review the aged trial balance for significant past due accounts.

D. Obtain an understanding of the business purpose of transactions that resulted in accounts receivable balances.

E. Review loan agreements for indications of whether accounts receivable have been factored or pledged.

F. Review the accounts receivable trial balance for amounts due from officers and employees.

G. Analyze unusual relationships between monthly accounts receivable balances and monthly accounts payable balances.

Audit Objectives for Property & Equipment

68. The entity has legal right to property and equipment acquired during the year.

69. Recorded property and equipment represent assets that actually exist at the balance sheet date.

70. Net property and equipment are properly valued at the balance sheet date.

Audit Procedures for Property & Equipment

A. Trace opening balances in the summary schedules to the prior year's audit working papers.

B. Review the provision for depreciation expense and determine that depreciable lives and methods used in the current year are consistent with those used in the prior year.

C. Determine that the responsibility for maintaining the property and equipment records is segregated from the responsibility for custody of property and equipment.

D. Examine deeds and title insurance certificates.

E. Perform cut-off tests to verify that property and equipment additions are recorded in the proper period.

F. Determine that property and equipment is adequately insured.

G. Physically examine all major property and equipment additions.

Number 3 (Estimated time —— 15 to 25 minutes)

The auditors' report below was drafted by Moore, a staff accountant of Tyler & Tyler, CPAs, at the completion of the audit of the financial statements of Park Publishing Co., Inc., for the year ended September 30, 1992. The report was submitted to the engagement partner who reviewed the audit working papers and properly concluded that an unqualified opinion should be issued. In drafting the report, Moore considered the following:

- During fiscal year 1992, Park changed its depreciation method. The engagement partner concurred with this change in accounting principle and its justification and Moore included an explanatory paragraph in the auditors' report.
- The 1992 financial statements are affected by an uncertainty concerning a lawsuit, the outcome of which cannot presently be estimated. Moore has included an explanatory paragraph in the auditors' report.
- The financial statements for the year ended September 30, 1991, are to be presented for comparative purposes. Tyler & Tyler previously audited these statements and expressed an unqualified opinion.

<u>Independent Auditors' Report</u>

To the Board of Directors of Park Publishing Co., Inc.:

We have audited the accompanying balance sheets of Park Publishing Co., Inc. as of September 30, 1992, and 1991, and the related statements of income and cash flows for the years then ended. These financial statements are the responsibility of the company's management.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are fairly presented. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a basis for determining whether any material modifications should be made to the accompanying financial statements.

As discussed in Note X to the financial statements, the company changed its method of computing depreciation in fiscal 1992.

In our opinion, except for the accounting change, with which we concur, the financial statements referred to above present fairly, in all material respects, the financial position of Park Publishing Co., Inc. as of September 30, 1992, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

As discussed in Note Y to the financial statements, the company is a defendant in a lawsuit alleging infringement of certain copyrights. The company has filed a counteraction, and preliminary hearings on both actions are in progress. Accordingly, any provision for liability is subject to adjudication of this matter.

Tyler & Tyler, CPAs
November 5, 1992

Required:

Identify the deficiencies in the auditors' report as drafted by Moore. Group the deficiencies by paragraph and in the order in which the deficiencies appear. Do **not** redraft the report.

Number 4 (Estimated time —— 15 to 25 minutes)

An auditor is required to obtain a sufficient understanding of each of the elements of an entity's internal control structure. This is necessary to plan the audit of the entity's financial statements and to assess control risk.

Required:

a. For what purposes should an auditor's understanding of the internal control structure elements be used in planning an audit?

b. What is required for an auditor to assess control risk at below the maximum level?

c. What should an auditor consider when seeking a further reduction in the planned assessed level of control risk?

d. What are an auditor's documentation requirements concerning an entity's internal control structure and the assessed level of control risk?

Number 5 (Estimated time —— 15 to 25 minutes)

Cook, CPA, has been engaged to audit the financial statements of General Department Stores, Inc., a continuing audit client, which is a chain of medium-sized retail stores. General's fiscal year will end on June 30, 1993, and General's management has asked Cook to issue the auditor's report by August 1, 1993. Cook will not have sufficient time to perform all of the necessary field work in July 1993, but will have time to perform most of the field work as of an interim date, April 30, 1993.

For the accounts to be tested at the interim date, Cook will also perform substantive tests covering the transactions of the final two months of the year. This will be necessary to extend Cook's conclusions to the balance sheet date.

Required:

a. Describe the factors Cook should consider before applying principal substantive tests to General's balance sheet accounts at April 30, 1993.

b. For accounts tested at April 30, 1993, describe how Cook should design the substantive tests covering the balances as of June 30, 1993, and the transactions of the final two months of the year.

Q-L

CANDIDATE NUMBER

Record your 7-digit candidate number in the boxes.

BUSINESS LAW

November 6, 1992; 8:30 A.M. to 12:00 Noon

The point values for each question, and estimated time allotments based primarily on point value, are as follows:

	Point Value	Estimated Minutes Minimum	Estimated Minutes Maximum
No. 1	60	90	110
No. 2	10	15	25
No. 3	10	15	25
No. 4	10	15	25
No. 5	10	15	25
Totals	100	150	210

INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

1. Record your 7-digit candidate number in the boxes provided at the upper right-hand corner of this page.

2. Question numbers 1 and 2 should be answered on the *Objective Answer Sheet,* which is pages 15 and 16 of your *Examination Answer Booklet*. You should attempt to answer all objective items. There is no penalty for incorrect responses. Since the objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the *Objective Answer Sheet* before the examination time is up. The objective portion of your examination will not be graded if you fail to record your answers on the *Objective Answer Sheet*. You will not be given additional time to record your answers.

3. Question numbers 3, 4, and 5 should be answered beginning on page 3 of the *Examination Answer Booklet*. If you have not completed answering a question on a page, fill in the appropriate spaces in the wording on the bottom of the page "**QUESTION NUMBER __ CONTINUES ON PAGE __.**" If you have completed answering a question, fill in the appropriate space in the wording on the bottom of the page "**QUESTION NUMBER __ ENDS ON THIS PAGE.**" Always begin the start of an answer to a question on the top of a new page.

   Record your 7-digit candidate number, state, and question number where indicated on pages 3 through 14.

4. *Additional ruled paper* is available if you need it. Additional pages should be numbered 14a, 14b, 14c, etc. If you used additional pages record the number of pages used on page 14, insert additional pages between pages 12 and 13, close the booklet, and staple. Do not staple booklet unless you used additional ruled paper.

5. Although the primary purpose of the examination is to test your knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.

6. You are required to turn in by the end of each session:

   a. Attendance Record Form, front page of Examination Answer Booklet;
   b. Objective Answer Sheet, pages 15 and 16 of Examination Answer Booklet;
   c. Remaining Portion of Examination Answer Booklet;
   d. Examination Question Booklet; and
   e. All unused examination materials.

   Your examination will not be graded unless the above listed items are handed in before leaving the examination room.

7. Unless otherwise instructed, if you want your *Examination Question Booklet* mailed to you, write your name and address in both places indicated on the back cover and place 52 cents postage in the space provided. Examination Question Booklets will be distributed no sooner than the day following the administration of this examination.

Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands of the United States.

Number 1 (Estimated time —— 90 to 110 minutes)

Instructions

Select the **best** answer for each of the following items. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of correct answers.

1. Which of the following statements is correct concerning the similarities between a limited partnership and a corporation?
   - A. Each is created under a statute and must file a copy of its certificate with the proper state authorities.
   - B. All corporate stockholders and all partners in a limited partnership have limited liability.
   - C. Both are recognized for federal income tax purposes as taxable entities.
   - D. Both are allowed statutorily to have perpetual existence.

2. A stockholder's right to inspect books and records of a corporation will be properly denied if the stockholder
   - A. Wants to use corporate stockholder records for a personal business.
   - B. Employs an agent to inspect the books and records.
   - C. Intends to commence a stockholder's derivative suit.
   - D. Is investigating management misconduct.

3. Which of the following must take place for a corporation to be voluntarily dissolved?
   - A. Passage by the board of directors of a resolution to dissolve.
   - B. Approval by the officers of a resolution to dissolve.
   - C. Amendment of the certificate of incorporation.
   - D. Unanimous vote of the stockholders.

4. Generally, a merger of two corporations requires
   - A. That a special meeting notice and a copy of the merger plan be given to all stockholders of both corporations.
   - B. Unanimous approval of the merger plan by the stockholders of both corporations.
   - C. Unanimous approval of the merger plan by the boards of both corporations.
   - D. That all liabilities owed by the absorbed corporation be paid before the merger.

5. Which of the following situations would cause a resulting trust to be created?

   I. Failure of an express trust.
   II. Application of the *cy pres* doctrine.
   III. Fulfillment of the trust purpose.

   - A. I and II.
   - B. I and III.
   - C. II and III.
   - D. I, II, and III.

6. Cox transferred assets into a trust under which Smart is entitled to receive the income for life. After Smart's death, the remaining assets are to be given to Mix. In 1991, the trust received rent of $1,000, stock dividends of $6,000, interest on certificates of deposit of $3,000, municipal bond interest of $4,000, and proceeds of $7,000 from the sale of bonds. Both Smart and Mix are still alive. What amount of the 1991 receipts should be allocated to trust principal?
   - A. $ 7,000
   - B. $ 8,000
   - C. $13,000
   - D. $15,000

7. If **not** expressly granted, which of the following implied powers would a trustee have?

   I. Power to sell trust property.
   II. Power to borrow from the trust.
   III. Power to pay trust expenses.

   - A. I and II.
   - B. I and III.
   - C. II and III.
   - D. I, II and III.

8. To which of the following trusts would the rule against perpetuities **not** apply?
   - A. Charitable.
   - B. Spendthrift.
   - C. Totten.
   - D. Constructive.

9. A decedent's will provided that the estate was to be divided among the decedent's issue, per capita and not per stirpes. If there are two surviving children and three grandchildren who are children of a predeceased child at the time the will is probated, how will the estate be divided?

A. ½ to each surviving child.
B. ⅓ to each surviving child and ⅙ to each grandchild.
C. ¼ to each surviving child and ⅙ to each grandchild.
D. ⅕ to each surviving child and grandchild.

10. Which of the following would ordinarily be distributed to a trust income beneficiary?

I. Royalties.
II. Stock received in a stock split.
III. Cash dividends.
IV. Settlements of claims for damages to trust property.

A. I and II.
B. I and III.
C. II and III.
D. II and IV.

11. On February 12, Harris sent Fresno a written offer to purchase Fresno's land. The offer included the following provision: "Acceptance of this offer must be by registered or certified mail, received by Harris no later than February 18 by 5:00 p.m. CST." On February 18, Fresno sent Harris a letter accepting the offer by private overnight delivery service. Harris received the letter on February 19. Which of the following statements is correct?

A. A contract was formed on February 19.
B. Fresno's letter constituted a counteroffer.
C. Fresno's use of the overnight delivery service was an effective form of acceptance.
D. A contract was formed on February 18 regardless of when Harris actually received Fresno's letter.

12. In determining whether the consideration requirement to form a contract has been satisfied, the consideration exchanged by the parties to the contract must be

A. Of approximately equal value.
B. Legally sufficient.
C. Exchanged simultaneously by the parties.
D. Fair and reasonable under the circumstances.

13. On June 15, Peters orally offered to sell a used lawn mower to Mason for $125. Peters specified that Mason had until June 20 to accept the offer. On June 16, Peters received an offer to purchase the lawn mower for $150 from Bronson, Mason's neighbor. Peters accepted Bronson's offer. On June 17, Mason saw Bronson using the lawn mower and was told the mower had been sold to Bronson. Mason immediately wrote to Peters to accept the June 15 offer. Which of the following statements is correct?

A. Mason's acceptance would be effective when received by Peters.
B. Mason's acceptance would be effective when mailed.
C. Peters' offer had been revoked and Mason's acceptance was ineffective.
D. Peters was obligated to keep the June 15 offer open until June 20.

14. Castle borrowed $5,000 from Nelson and executed and delivered to Nelson a promissory note for $5,000 due on April 30. On April 1 Castle offered, and Nelson accepted, $4,000 in full satisfaction of the note. On May 15, Nelson demanded that Castle pay the $1,000 balance on the note. Castle refused. If Nelson sued for the $1,000 balance Castle would

A. Win, because the acceptance by Nelson of the $4,000 constituted an accord and satisfaction.
B. Win, because the debt was unliquidated.
C. Lose, because the amount of the note was not in dispute.
D. Lose, because no consideration was given to Nelson in exchange for accepting only $4,000.

15. Rail, who was 16 years old, purchased an $800 computer from Elco Electronics. Rail and Elco are located in a state where the age of majority is 18. On several occasions Rail returned the computer to Elco for repairs. Rail was very unhappy with the computer. Two days after reaching the age of 18, Rail was still frustrated with the computer's reliability, and returned it to Elco, demanding an $800 refund. Elco refused, claiming that Rail no longer had a right to disaffirm the contract. Elco's refusal is

A. Correct, because Rail's multiple requests for service acted as a ratification of the contract.
B. Correct, because Rail could have transferred good title to a good faith purchaser for value.
C. Incorrect, because Rail disaffirmed the contract within a reasonable period of time after reaching the age of 18.
D. Incorrect, because Rail could disaffirm the contract at any time.

16. Which of the following statements is true with regard to the Statute of Frauds?
   - A. All contracts involving consideration of more than $500 must be in writing.
   - B. The written contract must be signed by all parties.
   - C. The Statute of Frauds applies to contracts that can be fully performed within one year from the date they are made.
   - D. The contract terms may be stated in more than one document.

17. On June 1, 1992, Decker orally guaranteed the payment of a $5,000 note Decker's cousin owed Baker. Decker's agreement with Baker provided that Decker's guaranty would terminate in 18 months. On June 3, 1992, Baker wrote Decker confirming Decker's guaranty. Decker did not object to the confirmation. On August 23, 1992, Decker's cousin defaulted on the note and Baker demanded that Decker honor the guaranty. Decker refused. Which of the following statements is correct?
   - A. Decker is liable under the oral guaranty because Decker did **not** object to Baker's June 3 letter.
   - B. Decker is **not** liable under the oral guaranty because it expired more than one year after June 1.
   - C. Decker is liable under the oral guaranty because Baker demanded payment within one year of the date the guaranty was given.
   - D. Decker is **not** liable under the oral guaranty because Decker's promise was **not** in writing.

18. Maco, Inc. and Kent contracted for Kent to provide Maco certain consulting services at an hourly rate of $20. Kent's normal hourly rate was $90 per hour, the fair market value of the services. Kent agreed to the $20 rate because Kent was having serious financial problems. At the time the agreement was negotiated, Maco was aware of Kent's financial condition and refused to pay more than $20 per hour for Kent's services. Kent has now sued to rescind the contract with Maco, claiming duress by Maco during the negotiations. Under the circumstances, Kent will
   - A. Win, because Maco refused to pay the fair market value of Kent's services.
   - B. Win, because Maco was aware of Kent's serious financial problems.
   - C. Lose, because Maco's actions did **not** constitute duress.
   - D. Lose, because Maco **cannot** prove that Kent, at the time, had **no** other offers to provide consulting services.

19. The statute of limitations for an alleged breach of contract
   - A. Does **not** apply if the contract was oral.
   - B. Requires that a lawsuit be commenced and a judgment rendered within a prescribed period of time.
   - C. Is determined on a case by case basis.
   - D. Generally commences on the date of the breach.

20. Miller negotiated the sale of Miller's liquor store to Jackson. Jackson asked to see the prior year's financial statements. Using the store's checkbook, Miller prepared a balance sheet and profit and loss statement as well as he could. Miller told Jackson to have an accountant examine Miller's records because Miller was not an accountant. Jackson failed to do so and purchased the store in reliance on Miller's financial statements. Jackson later learned that the financial statements included several errors that resulted in a material overstatement of assets and net income. Miller was not aware that the errors existed. Jackson sued Miller, claiming Miller misrepresented the store's financial condition and that Jackson relied on the financial statements in making the decision to acquire the store. Which of the following statements is correct?
   - A. Jackson will prevail if the errors in the financial statements were material.
   - B. Jackson will **not** prevail because Jackson's reliance on the financial statements was **not** reasonable.
   - C. Money damages is the only remedy available to Jackson if, in fact, Miller has committed a misrepresentation.
   - D. Jackson would be entitled to rescind the purchase even if the errors in the financial statements were **not** material.

21. Ferco, Inc. claims to be a creditor beneficiary of a contract between Bell and Allied Industries, Inc. Allied is indebted to Ferco. The contract between Bell and Allied provides that Bell is to purchase certain goods from Allied and pay the purchase price directly to Ferco until Allied's obligation is satisfied. Without justification, Bell failed to pay Ferco and Ferco sued Bell. Ferco will
   - A. Not prevail, because Ferco lacked privity of contract with either Bell or Allied.
   - B. Not prevail, because Ferco did **not** give any consideration to Bell.
   - C. Prevail, because Ferco was an intended beneficiary of the contract between Allied and Bell.
   - D. Prevail, provided Ferco was aware of the contract between Bell and Allied at the time the contract was entered into.

22. In negotiations with Andrews for the lease of Kemp's warehouse, Kemp orally agreed to pay one-half of the cost of the utilities. The written lease, later prepared by Kemp's attorney, provided that Andrews pay all of the utilities. Andrews failed to carefully read the lease and signed it. When Kemp demanded that Andrews pay all of the utilities, Andrews refused, claiming that the lease did not accurately reflect the oral agreement. Andrews also learned that Kemp intentionally misrepresented the condition of the structure of the warehouse during the negotiations between the parties. Andrews sued to rescind the lease and intends to introduce evidence of the parties' oral agreement about sharing the utilities and the fraudulent statements made by Kemp. The parol evidence rule will prevent the admission of evidence concerning the

	Oral agreement regarding who pays the utilities	*Fraudulent statements by Kemp*
A.	Yes	Yes
B.	No	Yes
C.	Yes	No
D.	No	No

23. Rogers and Lennon entered into a written computer consulting agreement that required Lennon to provide certain weekly reports to Rogers. The agreement also stated that Lennon would provide the computer equipment necessary to perform the services, and that Rogers' computer would not be used. As the parties were executing the agreement, they orally agreed that Lennon could use Rogers' computer. After executing the agreement, Rogers and Lennon orally agreed that Lennon would report on a monthly, rather than weekly, basis. The parties now disagree on Lennon's right to use Rogers' computer and how often Lennon must report to Rogers. In the event of a lawsuit between the parties, the parol evidence rule will

A. Not apply to any of the parties' agreements because the consulting agreement did **not** have to be in writing.
B. Not prevent Lennon from proving the parties' oral agreement that Lennon could use Rogers' computer.
C. Not prevent the admission into evidence of testimony regarding Lennon's right to report on a monthly basis.
D. Not apply to the parties' agreement to allow Lennon to use Rogers' computer because it was contemporaneous with the written agreement.

24. Wilcox Co. contracted with Ace Painters, Inc. for Ace to paint Wilcox's warehouse. Ace, without advising Wilcox, assigned the contract to Pure Painting Corp. Pure failed to paint Wilcox's warehouse in accordance with the contract specifications. The contract between Ace and Wilcox was silent with regard to a party's right to assign it. Which of the following statements is correct?

A. Ace remained liable to Wilcox despite the fact that Ace assigned the contract to Pure.
B. Ace would **not** be liable to Wilcox if Ace had notified Wilcox of the assignment.
C. Ace's duty to paint Wilcox's warehouse was nondelegable.
D. Ace's delegation of the duty to paint Wilcox's warehouse was a breach of the contract.

25. On June 15, 1990, Alpha, Inc. contracted with Delta Manufacturing, Inc. to buy a vacant parcel of land Delta owned. Alpha intended to build a distribution warehouse on the land because of its location near a major highway. The contract stated that: "Alpha's obligations hereunder are subject to the vacant parcel being rezoned to a commercial zoning classification by July 31, 1991." Which of the following statements is correct?

A. If the parcel is **not** rezoned by July 31, and Alpha refuses to purchase it, Alpha would **not** be in breach of contract.
B. If the parcel is rezoned by July 31, and Alpha refuses to purchase it, Delta would be able to successfully sue Alpha for specific performance.
C. The contract is **not** binding on either party because Alpha's performance is conditional.
D. If the parcel is rezoned by July 31, and Delta refuses to sell it, Delta's breach would **not** discharge Alpha's obligation to tender payment.

26. Ivor borrowed $420,000 from Lear Bank. At Lear's request, Ivor entered into an agreement with Ash, Kane, and Queen for them to act as co-sureties on the loan. The agreement between Ivor and the co-sureties provided that the maximum liability of each co-surety was: Ash, $84,000; Kane, $126,000; and Queen, $210,000. After making several payments, Ivor defaulted on the loan. The balance was $280,000. If Queen pays $210,000 and Ivor subsequently pays $70,000, what amounts may Queen recover from Ash and Kane?

A. $0 from Ash and $0 from Kane.
B. $42,000 from Ash and $63,000 from Kane.
C. $70,000 from Ash and $70,000 from Kane.
D. $56,000 from Ash and $84,000 from Kane.

27. Which of the following acts will always result in the total release of a compensated surety?
    A. The creditor extends the principal debtor's time to pay.
    B. The principal debtor's performance is tendered.
    C. The place of payment is changed.
    D. The principal debtor's obligation is partially released.

28. A distinction between a surety and a co-surety is that only a co-surety is entitled to
    A. Reimbursement (Indemnification).
    B. Subrogation.
    C. Contribution.
    D. Exoneration.

29. Green owes unsecured creditors: Rice, $1,500; Vick, $2,000; Young, $6,000; and Zinc, $1,750. Green has not paid any creditor since January 1, 1992. On March 15, 1992, Green's sole asset, a cabin cruiser, was seized by Xeno Marine Co. the holder of a perfected security interest in the boat. On July 1, 1992, Rice, Vick, and Zinc involuntarily petitioned Green into bankruptcy under Chapter 7 of the Federal Bankruptcy Code. If Green opposes the involuntary petition, the petition will be
    A. Upheld, because the three filing creditors are owed more than $5,000.
    B. Upheld, because one creditor is owed more than $5,000.
    C. Dismissed, because there are less than 12 creditors.
    D. Dismissed, because the boat was seized more than 90 days before the filing.

30. A party involuntarily petitioned into bankruptcy under Chapter 7 of the Federal Bankruptcy Code who succeeds in having the petition dismissed could recover

	Court costs and attorney's fees	*Compensatory damages*	*Punitive damages*
A.	Yes	Yes	Yes
B.	Yes	Yes	No
C.	No	Yes	Yes
D.	Yes	No	No

31. Under Chapter 11 of the Federal Bankruptcy Code, which of the following actions is necessary before the court may confirm a reorganization plan?
    A. Provision for full payment of administration expenses.
    B. Acceptance of the plan by all classes of claimants.
    C. Preparation of a contingent plan of liquidation.
    D. Appointment of a trustee.

32. Under Chapter 11 of the Federal Bankruptcy Code, which of the following would **not** be eligible for reorganization?
    A. Retail sole proprietorship.
    B. Advertising partnership.
    C. CPA professional corporation.
    D. Savings and loan corporation.

33. Which of the following negotiable instruments is subject to the UCC Commercial Paper Article?
    A. Corporate bearer bond with a maturity date of January 1, 2001.
    B. Installment note payable on the first day of each month.
    C. Warehouse receipt.
    D. Bill of lading payable to order.

34. Which of the following conditions, if present on an otherwise negotiable instrument, would affect the instrument's negotiability?
    A. The instrument is payable six months after the death of the maker.
    B. The instrument is payable at a definite time subject to an accelerated clause in the event of a default.
    C. The instrument is postdated.
    D. The instrument contains a promise to provide additional collateral if there is a decrease in value of the existing collateral.

35. West Corp. received a check that was originally made payable to the order of one of its customers, Ted Burns. The following endorsement was written on the back of the check:

> Ted Burns, without recourse, for collection only

Which of the following describes the endorsement?

	Special	*Restrictive*
A.	Yes	Yes
B.	No	No
C.	No	Yes
D.	Yes	No

36. One of the requirements to qualify as a holder of a negotiable bearer check is that the transferee must
    A. Receive the check that was originally made payable to bearer.
    B. Take the check in good faith.
    C. Give value for the check.
    D. Have possession of the check.

Items 37 through 39 are based on the following:

On August 1, 1992, Hall filed a voluntary petition under Chapter 7 of the Federal Bankruptcy Code.

Hall's assets are sufficient to pay general creditors 40% of their claims.

The following transactions occurred before the filing:

- On May 15, 1992, Hall gave a mortgage on Hall's home to National Bank to secure payment of a loan National had given Hall two years earlier. When the loan was made, Hall's twin was a National employee.
- On June 1, 1992, Hall purchased a boat from Olsen for $10,000 cash.
- On July 1, 1992, Hall paid off an outstanding credit card balance of $500. The original debt had been $2,500.

37. The National mortgage was
    A. Preferential, because National would be considered an insider.
    B. Preferential, because the mortgage was given to secure an antecedent debt.
    C. Not preferential, because Hall is presumed insolvent when the mortgage was given.
    D. Not preferential, because the mortgage was a security interest.

38. The payment to Olsen was
    A. Preferential, because the payment was made within 90 days of the filing of the petition.
    B. Preferential, because the payment enabled Olsen to receive more than the other general creditors.
    C. Not preferential, because Hall is presumed insolvent when the payment was made.
    D. Not preferential, because the payment was a contemporaneous exchange for new value.

39. The credit card payment was
    A. Preferential, because the payment was made within 90 days of the filing of the petition.
    B. Preferential, because the payment was on account of an antecedent debt.
    C. Not preferential, because the payment was for a consumer debt of less than $600.
    D. Not preferential, because the payment was less than 40% of the original debt.

40. A maker of a note will have a real defense against a holder in due course as a result of any of the following conditions **except**
    A. Discharge in bankruptcy.
    B. Forgery.
    C. Fraud in the execution.
    D. Lack of consideration.

41. A check has the following endorsements on the back:

Paul Folk without recourse
George Hopkins payment guaranteed
Ann Quarry collection guaranteed
Rachel Ott

Which of the following conditions occurring subsequent to the endorsements would discharge all of the endorsers?
    A. Lack of notice of dishonor.
    B. Late presentment.
    C. Insolvency of the maker.
    D. Certification of the check.

42. Burke stole several negotiable warehouse receipts from Grove Co. The receipts were deliverable to Grove's order. Burke endorsed Grove's name and sold the warehouse receipts to Federated Wholesalers, a bona fide purchaser. In an action by Federated against Grove,
    A. Grove will prevail, because Burke **cannot** validly negotiate the warehouse receipts.
    B. Grove will prevail, because the warehouser must be notified before any valid negotiation of a warehouse receipt is effective.
    C. Federated will prevail, because the warehouse receipts were converted to bearer instruments by Burke's endorsement.
    D. Federated will prevail, because it took the negotiable warehouse receipts as a bona fide purchaser for value.

43. Under a nonnegotiable bill of lading, a carrier who accepts goods for shipment, must deliver the goods to
    A. Any holder of the bill of lading.
    B. Any party subsequently named by the seller.
    C. The seller who was issued the bill of lading.
    D. The consignee of the bill of lading.

44. Under the UCC Investment Securities Article, a restriction on the transfer of corporate stock will only be valid against a transferee if the restriction is
   A. Contained in a stockholders' agreement.
   B. Stated on the face of the stock certificate.
   C. Placed on publicly traded stock.
   D. Part of a buy-sell contract.

45. Under the UCC Secured Transactions Article, which of the following conditions must be satisfied for a security interest to attach?
   A. The debtor must have title to the collateral.
   B. The debtor must agree to the creation of the security interest.
   C. The creditor must be in possession of part of the collateral.
   D. The creditor must properly file a financing statement.

46. Under the UCC Secured Transactions Article, when collateral is in a secured party's possession, which of the following conditions must also be satisfied to have attachment?
   A. There must be a written security agreement.
   B. The public must be notified.
   C. The secured party must receive consideration.
   D. The debtor must have rights to the collateral.

47. Under the UCC Secured Transaction Article, what is the effect of perfecting a security interest by filing a financing statement?
   A. The secured party can enforce its security interest against the debtor.
   B. The secured party has permanent priority in the collateral even if the collateral is removed to another state.
   C. The debtor is protected against all other parties who acquire an interest in the collateral after the filing.
   D. The secured party has priority in the collateral over most creditors who acquire a security interest in the same collateral after the filing.

48. A secured creditor wants to file a financing statement to perfect its security interest. Under the UCC Secured Transactions Article, which of the following must be included in the financing statement?
   A. A listing or description of the collateral.
   B. An after-acquired property provision.
   C. The creditor's signature.
   D. The collateral's location.

49. On July 8, Ace, a refrigerator wholesaler, purchased 50 refrigerators. This comprised Ace's entire inventory and was financed under an agreement with Rome Bank that gave Rome a security interest in all refrigerators on Ace's premises, all future acquired refrigerators, and the proceeds of sales. On July 12, Rome filed a financing statement that adequately identified the collateral. On August 15, Ace sold one refrigerator to Cray for personal use and four refrigerators to Zone Co. for its business. Which of the following statements is correct?
   A. The refrigerators sold to Zone will be subject to Rome's security interest.
   B. The refrigerator sold to Cray will **not** be subject to Rome's security interest.
   C. The security interest does **not** include the proceeds from the sale of the refrigerators to Zone.
   D. The security interest may **not** cover after-acquired property even if the parties agree.

50. Under the UCC Secured Transactions Article, if a debtor is in default under a payment obligation secured by goods, the secured party has the right to

	Peacefully repossess the goods without judicial process	*Reduce the claim to a judgment*	*Sell the goods and apply the proceeds toward the debt*
A.	Yes	Yes	Yes
B.	No	Yes	Yes
C.	Yes	Yes	No
D.	Yes	No	Yes

51. Which of the following would change if an asset is treated as personal property rather than as real property?

	Requirements for transfer	*Creditor's rights*
A.	Yes	No
B.	No	Yes
C.	Yes	Yes
D.	No	No

52. Sklar, Rich, and Cey own a building as joint tenants with the right of survivorship. Sklar gave Sklar's interest in the building to Marsh by executing and delivering a deed to Marsh. Neither Rich nor Cey consented to this transfer. Rich and Cey subsequently died. After their deaths, Marsh's interest in the building would consist of
   A. A ⅓ interest as a tenant in common.
   B. A ⅓ interest as a joint tenant.
   C. Total ownership due to the deaths of Rich and Cey.
   D. No interest because Rich and Cey did **not** consent to the transfer.

53. Which of the following forms of tenancy will be created if a tenant stays in possession of the leased premises without the landlord's consent, after the tenant's one-year written lease expires?
   A. Tenancy at will.
   B. Tenancy for years.
   C. Tenancy from period to period.
   D. Tenancy at sufferance.

54. For a deed to be effective between the purchaser and seller of real estate, one of the conditions is that the deed must
   A. Contain the signatures of the seller and purchaser.
   B. Contain the actual sales price.
   C. Be delivered by the seller with an intent to transfer title.
   D. Be recorded within the permissible statutory time limits.

55. Generally, in addition to being in writing, a real estate mortgage must
   A. Be signed by both the mortgagor and mortgagee.
   B. Be recorded to validate the mortgagee's rights against the mortgagor.
   C. Contain a description of the real estate covered by the mortgage.
   D. Contain the actual amount of the underlying debt and the interest rate.

56. Hart owned a building with a fair market value of $400,000. The building was covered by a $300,000 fire insurance policy containing an 80% co-insurance clause. What amount would Hart recover if a fire totally destroyed the building?
   A. $0
   B. $240,000
   C. $256,000
   D. $300,000

57. Daly tried to collect on a property insurance policy covering a house that was damaged by fire. The insurer denied recovery, alleging that Daly had no insurable interest in the house. In which of the following situations will the insurer prevail?
   A. The house belongs to a corporation of which Daly is a 50% stockholder.
   B. Daly is **not** the owner of the house but a long-term lessee.
   C. The house is held in trust for Daly's mother and, on her death, will pass to Daly.
   D. Daly gave an unsecured loan to the owner of the house to improve the house.

Items 58 through 60 are based on the following:

On February 1, Frost bought a building from Elgin, Inc. for $250,000. To complete the purchase, Frost borrowed $200,000 from Independent Bank and gave Independent a mortgage for that amount; gave Elgin a second mortgage for $25,000; and paid $25,000 in cash. Independent recorded its mortgage on February 2 and Elgin recorded its mortgage on March 12.

The following transaction also took place:

- On March 1, Frost gave Scott a $20,000 mortgage on the building to secure a personal loan Scott had previously made to Frost.
- On March 10, Scott recorded this mortgage.
- On March 15, Scott learned about both prior mortgages.
- On June 1, Frost stopped making payments on all the mortgages.
- On August 1, the mortgages were foreclosed. Frost, on that date, owed Independent, $195,000; Elgin, $24,000; and Scott, $19,000.

A judicial sale of the building resulted in proceeds of $220,000 after expenses were deducted. The above transactions took place in a notice-race jurisdiction.

58. What amount of the proceeds will Scott receive?
   A. $0
   B. $ 1,000
   C. $12,500
   D. $19,000

59. Why would Scott receive this amount?
   A. Scott knew of the Elgin mortgage.
   B. Scott's mortgage was recorded before Elgin's and before Scott knew of Elgin's mortgage.
   C. Elgin's mortgage was first in time.
   D. After Independent is fully paid, Elgin and Scott share the remaining proceeds equally.

60. Frost may redeem the property before the judicial sale only if
   A. There is a statutory right of redemption.
   B. It is probable that the sale price will result in a deficiency.
   C. All mortgages are paid in full.
   D. All mortgagees are paid a penalty fee.

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Numbers 2 and 3 (Estimated time —— 30 to 50 minutes)

Question Numbers 2 and 3 are based on the following information. Question Number 2 consists of Items 61 through 75. Question Number 3 is an essay question.

Butler Manufacturing Corp. planned to raise capital for a plant expansion by borrowing from banks and making several stock offerings. Butler engaged Weaver, CPA, to audit its December 31, 1989, financial statements. Butler told Weaver that the financial statements would be given to certain named banks and included in the prospectuses for the stock offerings.

In performing the audit, Weaver did not confirm accounts receivable and, as a result, failed to discover a material overstatement of accounts receivable. Also, Weaver was aware of a pending class action product liability lawsuit that was not disclosed in Butler's financial statements. Despite being advised by Butler's legal counsel that Butler's potential liability under the lawsuit would result in material losses, Weaver issued an unqualified opinion on Butler's financial statements.

In May 1990, Union Bank, one of the named banks, relied on the financial statements and Weaver's opinion in giving Butler a $500,000 loan.

Butler raised an additional $16,450,000 through the following stock offerings, which were sold completely:

- June 1990 — Butler made a $450,000 unregistered offering of Class B nonvoting common stock under Rule 504 of Regulation D of the Securities Act of 1933. This offering was sold over two years to 30 nonaccredited investors and 20 accredited investors by general solicitation. The SEC was notified eight days after the first sale of this offering.
- September 1990 — Butler made a $10,000,000 unregistered offering of Class A voting common stock under Rule 506 of Regulation D of the Securities Act of 1933. This offering was sold over two years to 200 accredited investors and 30 nonaccredited investors through a private placement. The SEC was notified 14 days after the first sale of this offering.
- November 1990 — Butler made a $6,000,000 unregistered offering of preferred stock under Rule 505 of Regulation D of the Securities Act of 1933. This offering was sold during a one-year period to 40 nonaccredited investors by private placement. The SEC was notified 18 days after the first sale of this offering.

Shortly after obtaining the Union loan, Butler began experiencing financial problems but was able to stay in business because of the money raised by the offerings. Butler was found liable in the product liability suit. This resulted in a judgment Butler could not pay. Butler also defaulted on the Union loan and was involuntarily petitioned into bankruptcy. This caused Union to sustain a loss and Butler's stockholders to lose their investments.

As a result:

- The SEC claimed that all three of Butler's offerings were made improperly and were not exempt from registration.
- Union sued Weaver for
  - Negligence
  - Common Law Fraud
- The stockholders who purchased Butler's stock through the offerings sued Weaver, alleging fraud under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934.

These transactions took place in a jurisdiction providing for accountant's liability for negligence to known and intended users of financial statements.

Number 2 (10 points)

Instructions

Question Number 2 consists of 15 items. Select the **best** answer for each item. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Answer all items.** Your grade will be based on the total number of correct answers.

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

Item

99. Does the SEC regulate the securities industry?

Answer Sheet

Item	Yes	No
99	●	(N)

Required:

a. Items 61 through 65 are questions related to the June 1990 offering made under Rule 504 of Regulation D of the Securities Act of 1933. For each item, indicate your answer by blackening either yes (Y) or no (N) on the Objective Answer Sheet.

61. Did the offering comply with the dollar limitation of Rule 504?
62. Did the offering comply with the method of sale restrictions?
63. Was the offering sold during the applicable time limit?
64. Was the SEC notified timely of the first sale of the securities?
65. Was the SEC correct in claiming that this offering was not exempt from registration?

b. Items 66 through 70 are questions related to the September 1990 offering made under Rule 506 of Regulation D of the Securities Act of 1933. For each item, indicate your answer by blackening either yes (Y) or no (N) on the Objective Answer Sheet.

66. Did the offering comply with the dollar limitation of Rule 506?
67. Did the offering comply with the method of sale restrictions?
68. Was the offering sold to the correct number of investors?
69. Was the SEC notified timely of the first sale of the securities?
70. Was the SEC correct in claiming that this offering was not exempt from registration?

c. Items 71 through 75 are questions related to the November 1990 offering made under Rule 505 of Regulation D of the Securities Act of 1933. For each item, indicate your answer by blackening either yes (Y) or no (N) on the Objective Answer Sheet.

71. Did the offering comply with the dollar limitation of Rule 505?
72. Was the offering sold during the applicable time limit?
73. Was the offering sold to the correct number of investors?
74. Was the SEC notified timely of the first sale of the securities?
75. Was the SEC correct in claiming that this offering was not exempt from registration?

Number 3 (10 points)

Question Number 3 is an essay question based on the information presented for Question Number 2 on page 56.

Required:
Answer the following questions and give the reasons for your conclusions:

a. Will Union be successful in its suit against Weaver for:

1. Negligence?
2. Common law fraud?

b. Will the stockholders who purchased Butler's stock through the 1990 offerings succeed against Weaver under the anti-fraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934?

Number 4 (Estimated time —— 15 to 25 minutes)

Exotic Pets, Inc. hired Peterson to be the manager of one of its stores. Exotic sells a wide variety of animals. Peterson was given considerable authority by Exotic to operate the store, including the right to buy inventory. Peterson was told that any inventory purchase exceeding $2,000 required the approval of Exotic's general manager.

On June 1, 1992, Peterson contracted with Creatures Corp. to buy snakes for $3,100. Peterson had regularly done business with Creatures on Exotic's behalf in the past, and on several occasions had bought $1,000 to $1,750 worth of snakes from Creatures. Creatures was unaware of the limitation on Peterson's authority to buy inventory.

Peterson occasionally would buy, for Exotic, a certain breed of dog from Premier Breeders, Inc., which was owned by Peterson's friend. Whenever Exotic bought dogs from Premier, Premier paid Peterson 5% of the purchase price as an incentive to do more business with Premier. Exotic's management was unaware of these payments to Peterson.

On June 20, 1992, Mathews went to the Exotic store managed by Peterson to buy a ferret. Peterson allowed Mathews to handle one of the ferrets. Peterson knew that this particular ferret had previously bitten one of the store's clerks. Mathews was bitten by the ferret and seriously injured.

On July 23, 1992, Peterson bought paint and brushes for $30 from Handy Hardware. Peterson charged the purchase to Exotic's account at Handy. Peterson intended to use the paint and brushes to repaint the pet showroom. Exotic's management had never specifically discussed with Peterson whether Peterson had the authority to charge purchases at Handy. Although Exotic paid the Handy bill, Exotic's president believes Peterson is obligated to reimburse Exotic for the charges.

On August 1, 1992, Exotic's president learned of the Creatures contract and advised Creatures that Exotic would neither accept delivery of the snakes, nor pay for them, because Peterson did not have the authority to enter into the contract.

Exotic's president has also learned about the incentive payments Premier made to Peterson.

Exotic has taken the following positions:

- It is not liable to Creatures because Peterson entered into the contract without Exotic's consent.
- Peterson is obligated to reimburse Exotic for the charges incurred by Peterson at Handy Hardware.
- Peterson is liable to Exotic for the incentive payments received from Premier.

Mathews has sued both Peterson and Exotic for the injuries sustained from the ferret bite.

Required:

a. State whether Exotic's positions are correct and give the reasons for your conclusions.

b. State whether Mathews will prevail in the lawsuit against Exotic and Peterson and give the reasons for your conclusions.

Number 5 (Estimated time —— 15 to 25 minutes)

Debco Electronics, Inc. sells various brands of computer equipment to retail and business customers. An audit of Debco's 1991 financial statements has revealed the following transactions:

- On September 1, 1991, a Debco salesperson orally agreed to sell Rapid Computers, Inc. eight TMI computers for $11,000, to be delivered on October 15, 1991. Rapid sells computers to the general public. The Debco salesperson sent Rapid a signed confirmation of the sales agreement. Rapid received the confirmation on September 3, but did not respond to it. On October 15, 1991, Debco tendered delivery of the computers to Rapid. Rapid refused to accept delivery, claiming it had no obligation to buy the computers because it had not signed a contract with Debco.
- On October 12, 1991, Debco mailed TMI Computers, Inc. a signed purchase order for certain specified computers for delivery by November 30, 1991. The purchase order also stated the following:

  > This purchase order will not be withdrawn on or before October 31, 1991. You must accept by that date or we will assume you cannot meet our terms. Ship F.O.B. - our loading dock.

  TMI received the purchase order on October 15, 1991.
- On October 25, Debco mailed the following signed correspondence to TMI, which TMI received on October 29:

  > Cancel our October 12, 1991, purchase order. We have found a better price on the computers.
- On October 31, 1991, TMI mailed the following signed correspondence to Debco, which Debco received on November 3:

  > We have set aside the computers you ordered and turned down other offers for them. Therefore, we will ship the computers to you for delivery by November 30, 1991, F.O.B. — your loading dock with payment terms 2/10; net 30.

There were no further communications between TMI and Debco.

TMI shipped the computers on November 15, and Debco received them on November 29. Debco refused to accept delivery. In justifying its refusal to accept delivery, Debco claimed the following:

- Its October 25 correspondence prevented the formation of a contract between Debco and TMI;
- TMI's October 31 correspondence was not an effective acceptance because it was not received by Debco until November 3;
- TMI's October 31 correspondence was not an effective acceptance because it added payment terms to Debco's purchase order.

Debco, Rapid, and TMI are located in a jurisdiction that has adopted the UCC.

Required:

a. State whether Rapid's claim is correct and give the reasons for your conclusions.

b. State whether Debco's claims are correct with regard to the transaction involving TMI and give the reasons for your conclusions.

Q-T

CANDIDATE NUMBER

Record your 7-digit candidate number in the boxes.

ACCOUNTING THEORY

November 6, 1992; 1:30 P.M. to 5:00 P.M.

The point values for each question, and estimated time allotments based primarily on point value, are as follows:

	Point Value	Estimated Minutes Minimum	Estimated Minutes Maximum
No. 1	60	90	110
No. 2	10	15	25
No. 3	10	15	25
No. 4	10	15	25
No. 5	10	15	25
Totals	100	150	210

INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

1. Record your 7-digit candidate number in the boxes provided at the upper right-hand corner of this page.

2. Question numbers 1 and 2 should be answered on the *Objective Answer Sheet,* which is pages 15 and 16 of your *Examination Answer Booklet*. You should attempt to answer all objective items. There is no penalty for incorrect responses. Since the objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the *Objective Answer Sheet* before the examination time is up. The objective portion of your examination will not be graded if you fail to record your answers on the *Objective Answer Sheet*. You will not be given additional time to record your answers.

3. Question numbers 3, 4, and 5 should be answered beginning on page 3 of the *Examination Answer Booklet*. If you have not completed answering a question on a page, fill in the appropriate spaces in the wording on the bottom of the page "**QUESTION NUMBER __ CONTINUES ON PAGE __.**" If you have completed answering a question, fill in the appropriate space in the wording on the bottom of the page "**QUESTION NUMBER __ ENDS ON THIS PAGE.**" Always begin the start of an answer to a question on the top of a new page.

   Record your 7-digit candidate number, state, and question number where indicated on pages 3 through 14.

4. *Additional ruled paper* is available if you need it. Additional pages should be numbered 14a, 14b, 14c, etc. If you used additional pages record the number of pages used on page 14, insert additional pages between pages 12 and 13, close the booklet, and staple. Do not staple booklet unless you used additional ruled paper.

5. Although the primary purpose of the examination is to test your knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.

6. You are required to turn in by the end of each session:

   a. Attendance Record Form, front page of Examination Answer Booklet;
   b. Objective Answer Sheet, pages 15 and 16 of Examination Answer Booklet;
   c. Remaining Portion of Examination Answer Booklet;
   d. Examination Question Booklet; and
   e. All unused examination materials.

   Your examination will not be graded unless the above listed items are handed in before leaving the examination room.

7. Unless otherwise instructed, if you want your *Examination Question Booklet* mailed to you, write your name and address in both places indicated on the back cover and place 52 cents postage in the space provided. Examination Question Booklets will be distributed no sooner than the day following the administration of this examination.

Prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of all states, the District of Columbia, Guam, Puerto Rico, and the Virgin Islands of the United States.

Number 1 (Estimated time —— 90 to 110 minutes)

Instructions

Select the **best** answer for each of the following items relating to **a variety of issues in accounting.** Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answers. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of correct answers.

1. Which of the following accounting pronouncements is the most authoritative?
   A. FASB Statement of Financial Accounting Concepts.
   B. FASB Technical Bulletin.
   C. AICPA Accounting Principles Board Opinion.
   D. AICPA Statement of Position.

2. According to the FASB conceptual framework, which of the following relates to both relevance and reliability?
   A. Comparability.
   B. Feedback value.
   C. Verifiability.
   D. Timeliness.

3. According to the FASB conceptual framework, an entity's revenue may result from
   A. A decrease in an asset from primary operations.
   B. An increase in an asset from incidental transactions.
   C. An increase in a liability from incidental transactions.
   D. A decrease in a liability from primary operations.

4. After being held for 40 days, a 120-day 12% interest-bearing note receivable was discounted at a bank at 15%. The proceeds received from the bank equal
   A. Maturity value less the discount at 12%.
   B. Maturity value less the discount at 15%.
   C. Face value less the discount at 12%.
   D. Face value less the discount at 15%.

5. On December 31, 1991, Deal, Inc. failed to accrue the December 1991 sales salaries that were payable on January 6, 1992. What is the effect of the failure to accrue sales salaries on working capital and cash flows from operating activities in Deal's 1991 financial statements?

	Working capital	*Cash flows from operating activities*
A.	Overstated	No effect
B.	Overstated	Overstated
C.	No effect	Overstated
D.	No effect	No effect

6. White Co. wants to convert its 1991 financial statements from the accrual basis of accounting to the cash basis. Both supplies inventory and office salaries payable increased between January 1, 1991, and December 31, 1991. To obtain 1991 cash basis net income, how should these increases be added to or deducted from accrual basis net income?

	Supplies inventory	*Office salaries payable*
A.	Deducted	Deducted
B.	Deducted	Added
C.	Added	Deducted
D.	Added	Added

7. In June 1992, Northan Retailers sold refundable merchandise coupons. Northan received $10 for each coupon redeemable from July 1 to December 31, 1992, for merchandise with a retail price of $11. At June 30, 1992, how should Northan report these coupon transactions?
   A. Unearned revenues at the merchandise's retail price.
   B. Unearned revenues at the cash received amount.
   C. Revenues at the merchandise's retail price.
   D. Revenues at the cash received amount.

8. A company used the percentage-of-completion method of accounting for a 5-year construction contract. Which of the following items will the company use to calculate the income recognized in the third year?

	Progress billings to date	*Income previously recognized*
A.	Yes	No
B.	No	Yes
C.	No	No
D.	Yes	Yes

9. Pie Co. uses the installment sales method to recognize revenue. Customers pay the installment notes in 24 equal monthly amounts, which include 12% interest. What is an installment note's receivable balance six months after the sale?
   A. 75% of the original sales price.
   B. Less than 75% of the original sales price.
   C. The present value of the remaining monthly payments discounted at 12%.
   D. Less than the present value of the remaining monthly payments discounted at 12%.

10. During 1991, Peg Construction Co. recognized substantial gains from:

- An increase in value of a foreign customer's remittance caused by a major foreign currency revaluation.
- A court-ordered increase in a completed long-term construction contract's price due to design changes.

Should these gains be included in continuing operations or reported as an extraordinary item in Peg's 1991 income statement?

	Gain from major currency revaluation	*Gain from increase in contract's price*
A.	Continuing operations	Continuing operations
B.	Extraordinary item	Continuing operations
C.	Extraordinary item	Extraordinary item
D.	Continuing operations	Extraordinary item

11. When the allowance method of recognizing bad debt expense is used, the allowance would decrease when a(an)
   A. Account previously written off is collected.
   B. Account previously written off becomes collectible.
   C. Specific uncollectible account is written off.
   D. Provision for uncollectible accounts is recorded.

12. Jel Co., a consignee, paid the freight costs for goods shipped from Dale Co., a consignor. These freight costs are to be deducted from Jel's payment to Dale when the consignment goods are sold. Until Jel sells the goods, the freight costs should be included in Jel's
   A. Cost of goods sold.
   B. Freight-out costs.
   C. Selling expenses.
   D. Accounts receivable.

13. At October 31, 1992, Dingo, Inc. had cash accounts at three different banks. One account balance is segregated solely for a November 15, 1992, payment into a bond sinking fund. A second account, used for branch operations, is overdrawn. The third account, used for regular corporate operations, has a positive balance. How should these accounts be reported in Dingo's October 31, 1992, classified balance sheet?
   A. The segregated account should be reported as a noncurrent asset, the regular account should be reported as a current asset, and the overdraft should be reported as a current liability.
   B. The segregated and regular accounts should be reported as current assets, and the overdraft should be reported as a current liability.
   C. The segregated account should be reported as a noncurrent asset, and the regular account should be reported as a current asset net of the overdraft.
   D. The segregated and regular accounts should be reported as current assets net of the overdraft.

14. The original cost of an inventory item is below both replacement cost and net realizable value. The net realizable value less normal profit margin is below the original cost. Under the lower of cost or market method, the inventory item should be valued at
   A. Replacement cost.
   B. Net realizable value.
   C. Net realizable value less normal profit margin.
   D. Original cost.

15. Jones Wholesalers stocks a changing variety of products. Which inventory costing method will be most likely to give Jones the lowest ending inventory when its product lines are subject to specific price increases?
   A. Specific identification.
   B. Weighted average.
   C. Dollar-value LIFO.
   D. FIFO periodic.

16. An inventory loss from a market price decline occurred in the first quarter, and the decline was not expected to reverse during the fiscal year. However, in the third quarter the inventory's market price recovery exceeded the market decline that occurred in the first quarter. For interim financial reporting, the dollar amount of net inventory should

A. Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of the decrease in the first quarter.
B. Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of the market price recovery.
C. Decrease in the first quarter by the amount of the market price decline and **not** be affected in the third quarter.
D. Not be affected in either the first quarter or the third quarter.

17. Invern, Inc. has a self-insurance plan. Each year, retained earnings is appropriated for contingencies in an amount equal to insurance premiums saved less recognized losses from lawsuits and other claims. As a result of a 1991 accident, Invern is a defendant in a lawsuit in which it will probably have to pay damages of $190,000. What are the effects of this lawsuit's probable outcome on Invern's 1991 financial statements?

A. An increase in expenses and **no** effect on liabilities.
B. An increase in both expenses and liabilities.
C. No effect on expenses and an increase in liabilities.
D. No effect on either expenses or liabilities.

18. When collectibility is reasonably assured, the excess of the subscription price over the stated value of the no par common stock subscribed should be recorded as

A. No par common stock
B. Additional paid-in capital when the subscription is recorded.
C. Additional paid-in capital when the subscription is collected.
D. Additional paid-in capital when the common stock is issued.

19. When a company goes through a quasi-reorganization, its balance sheet carrying amounts are stated at:

A. Original cost.
B. Original book value.
C. Replacement value.
D. Fair value.

Items 20 and 21 are based on the following:

Deed Co. owns 2% of Beck Cosmetic Retailers. A property dividend by Beck consisted of merchandise with a fair value lower than the listed retail price. Deed in turn gave the merchandise to its employees as a holiday bonus.

20. How should Deed report the receipt and distribution of the merchandise in its income statement?

A. At fair value for both dividend revenue and employee compensation expense.
B. At listed retail price for both dividend revenue and employee compensation expense.
C. At fair value for dividend revenue and listed retail price for employee compensation expense.
D. By disclosure only.

21. How should Deed report the receipt and distribution of the merchandise in its statement of cash flows?

A. As both an inflow and outflow for operating activities.
B. As both an inflow and outflow for investing activities.
C. As an inflow for investing activities and outflow for operating activities.
D. As a noncash activity.

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22. A corporation issuing stock should charge retained earnings for the market value of the shares issued in a(an)

A. Employee stock bonus.
B. Pooling of interests.
C. 10% stock dividend.
D. 2-for-1 stock split.

23. On January 31, 1992, Pack, Inc. split its common stock 2 for 1, and Young, Inc. issued a 5% stock dividend. Both companies issued their December 31, 1991, financial statements on March 1, 1992. Should Pack's 1991 earnings per share (EPS) take into consideration the stock split, and should Young's 1991 EPS take into consideration the stock dividend?

	Pack's 1991 EPS	*Young's 1991 EPS*
A.	Yes	No
B.	No	No
C.	Yes	Yes
D.	No	Yes

24. Vik Auto and King Clothier exchanged goods, held for resale, with equal fair values. Each will use the other's goods to promote their own products. The retail price of the car that Vik gave up is less than the retail price of the clothes received. What profit should Vik recognize for the nonmonetary exchange?
   A. A profit is **not** recognized.
   B. A profit equal to the difference between the retail prices of the clothes received and the car.
   C. A profit equal to the difference between the retail price and the cost of the car.
   D. A profit equal to the difference between the fair value and the cost of the car.

25. At December 31, 1991, Taos Co. estimates that its employees have earned vacation pay of $100,000. Employees will receive their vacation pay in 1992. Should Taos accrue a liability at December 31, 1991, if the rights to this compensation accumulated over time or if the rights are vested?

	Accumulated	*Vested*
A.	Yes	No
B.	No	No
C.	Yes	Yes
D.	No	Yes

26. On July 31, 1991, Tern Co. amended its single employee defined benefit pension plan by granting increased benefits for services provided prior to 1991. This prior service cost will be reflected in the financial statement(s) for
   A. Years before 1991 only.
   B. Year 1991 only.
   C. Year 1991, and years before and following 1991.
   D. Year 1991, and following years only.

27. Lease M does not contain a bargain purchase option, but the lease term is equal to 90% of the estimated economic life of the leased property. Lease P does not transfer ownership of the property to the lessee at the end of the lease term, but the lease term is equal to 75% of the estimated economic life of the leased property. How should the lessee classify these leases?

	Lease M	*Lease P*
A.	Capital lease	Operating lease
B.	Capital lease	Capital lease
C.	Operating lease	Capital lease
D.	Operating lease	Operating lease

28. On January 1, 1991, Sip Co. signed a 5-year contract enabling it to use a patented manufacturing process beginning in 1991. A royalty is payable for each product produced, subject to a minimum annual fee. Any royalties in excess of the minimum will be paid annually. On the contract date, Sip prepaid a sum equal to two years' minimum annual fees. In 1991, only minimum fees were incurred. The royalty prepayment should be reported in Sip's December 31, 1991, financial statements as
   A. An expense only.
   B. A current asset and an expense.
   C. A current asset and noncurrent asset.
   D. A noncurrent asset.

29. Malden, Inc. has two patents that have allegedly been infringed by competitors. After investigation, legal counsel informed Malden that it had a weak case on patent A34 and a strong case in regard to patent B19. Malden incurred additional legal fees to stop infringement on B19. Both patents have a remaining legal life of 8 years. How should Malden account for these legal costs incurred relating to the two patents?
   A. Expense costs for A34 and capitalize costs for B19.
   B. Expense costs for both A34 and B19.
   C. Capitalize costs for both A34 and B19.
   D. Capitalize costs for A34 and expense costs for B19.

30. Pal Corp.'s 1991 dividend income included only part of the dividend received from its Ima Corp. investment. The balance of the dividend reduced Pal's carrying amount for its Ima investment. This reflects that Pal accounts for its Ima investment by the
   A. Cost method, and only a portion of Ima's 1991 dividends represent earnings after Pal's acquisition.
   B. Cost method, and its carrying amount exceeded the proportionate share of Ima's market value.
   C. Equity method, and Ima incurred a loss in 1991.
   D. Equity method, and its carrying amount exceeded the proportionate share of Ima's market value.

31. Penn, Inc., a manufacturing company, owns 75% of the common stock of Sell, Inc., an investment company. Sell owns 60% of the common stock of Vane, Inc., an insurance company. In Penn's consolidated financial statements, should consolidation accounting or equity method accounting be used for Sell and Vane?
   A. Consolidation used for Sell and equity method used for Vane.
   B. Consolidation used for both Sell and Vane.
   C. Equity method used for Sell and consolidation used for Vane.
   D. Equity method used for both Sell and Vane.

32. Which of the following conditions would cause a business combination to be accounted for by the purchase method?
    A. The combined corporation intends to dispose of duplicate facilities within one year of the combination.
    B. Cash is to be used to acquire 2% of the outstanding stock of one of the combining companies.
    C. After the combination is consummated, one of the combining companies will be a subsidiary of another combining company.
    D. Before the combination is consummated, one of the combining companies holds 15% of the outstanding stock of another of the combining companies.

33. On January 1, 1991, Prim, Inc. acquired all the outstanding common shares of Scarp, Inc. for cash equal to the book value of the stock. The carrying amounts of Scarp's assets and liabilities approximated their fair values, except that the carrying amount of its building was more than fair value. In preparing Prim's 1991 consolidated income statement, which of the following adjustments would be made?
    A. Depreciation expense would be decreased and goodwill amortization would be recognized.
    B. Depreciation expense would be increased and goodwill amortization would be recognized.
    C. Depreciation expense would be decreased and **no** goodwill amortization would be recognized.
    D. Depreciation expense would be increased and **no** goodwill amortization would be recognized.

34. A 70%-owned subsidiary company declares and pays a cash dividend. What effect does the dividend have on the retained earnings and minority interest balances in the parent company's consolidated balance sheet?
    A. No effect on either retained earnings or minority interest.
    B. No effect on retained earnings and a decrease in minority interest.
    C. Decreases in both retained earnings and minority interest.
    D. A decrease in retained earnings and **no** effect on minority interest.

35. On September 30, 1991, Payne, Inc. exchanged some of its shares for all of the common stock of Salem, Inc. in a business combination accounted for as a pooling of interests. Salem continued as a wholly-owned subsidiary of Payne. How should Salem's January 1, 1991, retained earnings and income for January 1 to September 30 be reported in 1991 consolidated statements?

	1/1/91 Retained earnings	*Income for 1/1 to 9/30/91*
A.	Added to consolidated retained earnings	Added to consolidated income
B.	Added to consolidated retained earnings	Excluded from consolidated income
C.	Added to consolidated additional paid-in capital	Added to consolidated income
D.	Added to consolidated additional paid-in capital	Excluded from consolidated income

36. Cott Co.'s four business segments have revenues and identifiable assets expressed as percentages of Cott's total revenues and total assets as follows:

	Revenues	*Assets*
Ebon	64%	66%
Fair	14%	18%
Gel	14%	4%
Hak	8%	12%
	100%	100%

Which of these business segments are deemed to be reportable segments?
    A. Ebon only.
    B. Ebon and Fair only.
    C. Ebon, Fair, and Gel only.
    D. Ebon, Fair, Gel, and Hak.

37. Which of the following should be disclosed in a summary of significant accounting policies?

  I. Management's intention to maintain or vary the dividend payout ratio.
  II. Criteria for determining which investments are treated as cash equivalents.
  III. Composition of the sales order backlog by segment.

    A. I only.
    B. I and III.
    C. II only.
    D. II and III.

38. Heath Co.'s current ratio is 4:1. Which of the following transactions would normally increase its current ratio?
    A. Purchasing inventory on account.
    B. Selling inventory on account.
    C. Collecting an account receivable.
    D. Purchasing machinery for cash.

39. During a period of inflation in which a liability account balance remains constant, which of the following occurs?
    A. A purchasing power gain, if the item is a nonmonetary liability.
    B. A purchasing power gain, if the item is a monetary liability.
    C. A purchasing power loss, if the item is a nonmonetary liability.
    D. A purchasing power loss, if the item is a monetary liability.

40. Manhof Co. prepares supplementary reports on income from continuing operations on a current cost basis in accordance with FASB Statement No. 89, *Financial Reporting and Changing Prices.* How should Manhof compute cost of goods sold on a current cost basis?
    A. Number of units sold times average current cost of units during the year.
    B. Number of units sold times current cost of units at year end.
    C. Number of units sold times current cost of units at the beginning of the year.
    D. Beginning inventory at current cost plus cost of goods purchased less ending inventory at current cost.

41. Rein Inc. reported deferred tax assets and deferred tax liabilities at the end of 1990 and at the end of 1991. According to FASB Statements No. 96 and No. 109, *Accounting for Income Taxes,* for the year ended 1991 Rein should report deferred income tax expense or benefit equal to the
    A. Decrease in the deferred tax assets.
    B. Increase in the deferred tax liabilities.
    C. Amount of the current tax liability plus the sum of the net changes in deferred tax assets and deferred tax liabilities.
    D. Sum of the net changes in deferred tax assets and deferred tax liabilities.

42. Buc Co. receives deposits from its customers to protect itself against nonpayments for future services. These deposits should be classified by Buc as
    A. A liability.
    B. Revenue.
    C. A deferred credit deducted from accounts receivable.
    D. A contra account.

43. Smith owns several works of art. At what amount should these art works be reported in Smith's personal financial statements?
    A. Original cost.
    B. Insured amount.
    C. Smith's estimate.
    D. Appraised value.

44. A statement of cash flows for a development stage enterprise
    A. Is the same as that of an established operating enterprise and, in addition, shows cumulative amounts from the enterprise's inception.
    B. Shows only cumulative amounts from the enterprise's inception.
    C. Is the same as that of an established operating enterprise, but does **not** show cumulative amounts from the enterprise's inception.
    D. Is **not** presented.

45. Nile Co.'s cost allocation and product costing procedures follow activity-based costing principles. Activities have been identified and classified as being either value-adding or nonvalue-adding as to each product. Which of the following activities, used in Nile production process, is nonvalue-adding?
    A. Design engineering activity.
    B. Heat treatment activity.
    C. Drill press activity.
    D. Raw materials storage activity.

46. The most likely strategy to reduce the breakeven point, would be to
    A. Increase both the fixed costs and the contribution margin.
    B. Decrease both the fixed costs and the contribution margin.
    C. Decrease the fixed costs and increase the contribution margin.
    D. Increase the fixed costs and decrease the contribution margin.

47. In computing the current period's manufacturing cost per equivalent unit, the FIFO method of process costing considers current period costs
    A. Only.
    B. Plus cost of beginning work-in-process inventory.
    C. Less cost of beginning work-in-process inventory.
    D. Plus cost of ending work-in-process inventory.

48. Residual income of an investment center is the center's
   A. Income plus the imputed interest on its invested capital.
   B. Income less the imputed interest on its invested capital.
   C. Contribution margin plus the imputed interest on its invested capital.
   D. Contribution margin less the imputed interest on its invested capital.

49. Which of the following characteristics represent an advantage of the internal rate of return technique over the accounting rate of return technique in evaluating a project?

I. Recognition of the project's salvage value.
II. Emphasis on cash flows.
III. Recognition of the time value of money.

   A. I only.
   B. I and II.
   C. II and III.
   D. I, II, and III.

50. To assist in an investment decision, Gift Co. selected the most likely sales volume from several possible outcomes. Which of the following attributes would that selected sales volume reflect?
   A. The mid-point of the range.
   B. The median.
   C. The greatest probability.
   D. The expected value.

51. Interperiod equity is an objective of financial reporting for governmental entities. According to the Governmental Accounting Standards Board, is interperiod equity fundamental to public administration and is it a component of accountability?

	Fundamental to public administration	*Component of accountability*
A.	Yes	No
B.	No	No
C.	No	Yes
D.	Yes	Yes

52. The appropriations control account of a governmental unit is debited when
   A. Supplies are purchased.
   B. Expenditures are recorded.
   C. The budgetary accounts are closed.
   D. The budget is recorded.

53. The budgetary fund balance reserved for encumbrances account of a governmental-type fund is increased when
   A. The budget is recorded.
   B. Appropriations are recorded.
   C. Supplies previously ordered are received.
   D. A purchase order is approved.

54. Which of the following accounts should Moon City close at the end of its fiscal year?
   A. Vouchers payable.
   B. Expenditures.
   C. Fund balance.
   D. Fund balance—reserved for encumbrances.

55. In what fund type should the proceeds from special assessment bonds issued to finance construction of sidewalks in a new subdivision be reported?
   A. Agency fund.
   B. Special revenue fund.
   C. Enterprise fund.
   D. Capital projects fund.

56. The billings for transportation services provided to other governmental units are recorded by the internal service fund as
   A. Interfund exchanges.
   B. Intergovernmental transfers.
   C. Transportation appropriations.
   D. Operating revenues.

57. A hospital should report earnings from endowment funds that are restricted to a specific operating purpose as
   A. General fund revenues, when expended.
   B. Endowment fund revenues, when expended.
   C. General fund revenues, when received.
   D. Endowment fund revenues, when received.

58. River City has a defined contribution pension plan. How should River report the pension plan in its financial statements?
   A. Amortize any transition asset over the estimated number of years of current employees' service.
   B. Disclose in the notes to the financial statements the amount of the pension benefit obligation and the net assets available for benefits.
   C. Identify in the notes to financial statements the types of employees covered and the employer's and employees' obligations to contribute to the fund.
   D. Accrue a liability for benefits earned but **not** paid to fund participants.

59. Eureka City should issue a statement of cash flows for which of the following funds?

	Eureka City Hall capital projects fund	*Eureka Water Enterprise fund*
A.	No	Yes
B.	No	No
C.	Yes	No
D.	Yes	Yes

60. In the loan fund of a college, each of the following types of loans would be found **except**
   A. Faculty.
   B. Computer.
   C. Staff.
   D. Student.

Question Number 2 Begins on Page 70

Number 2 (Estimated time —— 15 to 25 minutes)

Instructions

Question Number 2 consists of 13 items. Select the **best** answer for each item. Use a No. 2 pencil to blacken the appropriate ovals on the Objective Answer Sheet to indicate your answer. **Answer all items.** Your grade will be based on the total number of correct answers.

Items 61 through 68 are based on the following:

Pucket Corp. is in the process of preparing its financial statements for the year ended December 31, 1991. Items 61 through 68 represent various transactions or situations that occurred during 1991.

Required:

For Items 61 through 68, select from the list of financial statement categories below the category in which the item should be presented, and blacken the corresponding oval on the Objective Answer Sheet. A financial statement category may be selected once, more than once, or not at all.

Financial Statement Categories:

A. Income from continuing operations, with **no** separate disclosure.
B. Income from continuing operations, with separate disclosure (either on the face of statement or in the notes).
C. Extraordinary items.
D. Separate component of stockholders' equity.
E. None of the above categories include this item.

Example:

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

Item

99. Recording of annual depreciation expense.

Answer Sheet

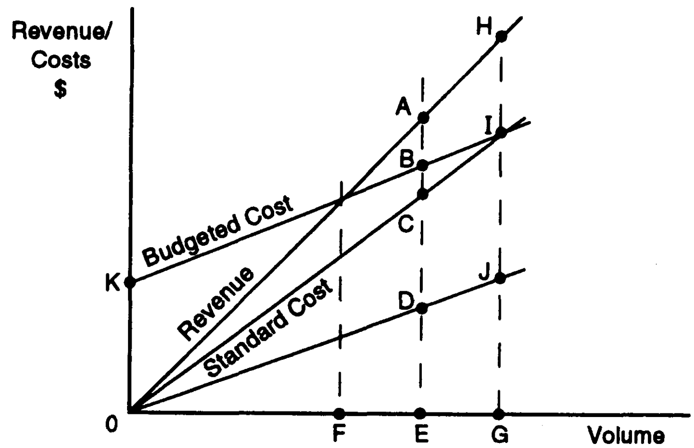
Item	Financial Statement Categories (select one)				
99	Ⓐ	●	Ⓒ	Ⓓ	Ⓔ

Items to be Answered:

61. An increase in the unrealized excess of cost over market value of short-term marketable equity securities.
62. An increase in the unrealized excess of cost over market value of long-term marketable equity securities.
63. Income from operations of a discontinued segment in the segment's disposal year, but before the measurement date.
64. A gain on remeasuring a foreign subsidiary's financial statements from the local currency into the functional currency.
65. A loss on translating a foreign subsidiary's financial statements from the functional local currency into the reporting currency.
66. A loss caused by a major earthquake in an area previously considered to be subject to only minor tremors.
67. The probable receipt of $1,000,000 from a pending lawsuit.
68. The purchase of research and development services. There were **no** other research and development activities.

Items 69 through 73 are based on the following:

The diagram below depicts a manufacturing total cost flexible budget line KI and standard cost line OI. Line OJ is parallel to line KI, and revenues are represented by line OH.



Required:

For Items 69 through 73, identify the line on the graph that represents each item. Indicate your answer by blackening the **two** ovals that define that line.

Example:

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

Item

99. The budgeted revenue at volume OE.

Answer Sheet

Item	Line End Points (select two)							
99	●	B	C	D	●	F	G	O

Items to be Answered:

69. The budgeted fixed cost at volume OE.
70. The budgeted variable cost at volume OE.
71. The standard gross profit at volume OE.
72. The budgeted gross profit at volume OE, assuming **no** change between beginning and ending inventories.
73. The normal capacity, assuming standard costs are based on normal capacity.

Number 3 (Estimated time —– 15 to 25 minutes)

On June 30, 1988, Corval Co. issued 15-year 12% bonds at a premium (effective yield 10%). On November 30, 1991, Corval transferred both cash and property to the bondholders to extinguish the entire debt. The fair value of the transferred property equaled its carrying amount. The fair value of the cash and property transferred exceeded the bonds carrying amount. [Ignore income taxes.]

Required:

a. Explain the purpose of the effective interest method and the effect of applying the method in 1988 on Corval's bond premium.

b. What would have been the effect on 1988 interest expense, net income, and the carrying amount of the bonds if Corval had incorrectly adopted the straight-line interest method instead of the effective interest method?

c. How should Corval calculate and report the effects of the November 30, 1991, transaction in its 1991 income statement? Why is this presentation appropriate?

d. How should Corval report the effects of the November 30, 1991, transaction in its statement of cash flows using the indirect method?

Number 4 (Estimated time —– 15 to 25 minutes)

On January 1, 1991, Windsor Corp. made the following changes in its accounting policies:

- Changed from the LIFO inventory method to the FIFO inventory method.
- Adopted the straight-line depreciation method for all future machinery acquisitions, but continued to use sum-of-the-years' digits depreciation method for all machinery purchased before 1991.
- Changed from the cash to the accrual basis of accounting for accumulated vacation pay.

Windsor prepares two-year comparative financial statements.

Required:

a. What type of accounting change is the change from the LIFO to the FIFO inventory costing method? How should Windsor report this change in its 1991 comparative financial statements?

b. What type of accounting change is Windsor's change from the sum-of-the-years' digits to the straight-line depreciation method for all machinery purchased after 1990? How should Windsor report this change?

c. What type of change occurs when recognition of vacation pay expense is changed from the cash basis to the accrual basis? How should Windsor report this change?

Number 5 (Estimated time —— 15 to 25 minutes)

Winter Sports Co. rents winter sports equipment to the public. Snowmobiles are depreciated by the double declining balance method. Before the season began, the estimated lives of several snowmobiles were extended because engines were replaced. Winter was given thirty days to pay for the engines. Winter gave the old engines to a local mechanic who agreed to provide repairs and maintenance service in the next year equal to the fair value of the engines. Rental skis, poles, and boots are capitalized and depreciated according to the inventory (appraisal) method.

Required:

a. How would Winter account for the purchase of the new engines and the transfer of the old engines to the local mechanic if the old engines' costs are

1. Known?
2. Unknown?

b. 1. What are two assumptions underlying use of an accelerated depreciation method?

2. How should Winter calculate the snowmobiles' depreciation?

c. How should Winter calculate and report the costs of the skis, poles, and boots in its balance sheets and income statements?

Uniform Certified Public Accountant Examination

OBJECTIVE ANSWER SHEET

IMPORTANT INSTRUCTIONS

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- Make no stray marks on this sheet.
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INCORRECT MARKS CORRECT MARK

Record your 7-digit candidate number in the boxes.

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CANDIDATE NUMBER

0	0	0	0	0	0	0
1	1	1	1	1	1	1
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9	9	9	9	9	9	9

VERSION 1

State ____________________

ACCOUNTING PRACTICE — PART I

November 4, 1992: 1:30 P.M. to 6:00 P.M.

1

INSTRUCTIONS TO CANDIDATES

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(30 points)

ANSWER 1	1	A	●	C	D	6	A	B	●	D	11	A	B	●	D	16	A	B	●	D
	2	●	B	C	D	7	●	B	C	D	12	●	B	C	D	17	A	●	C	D
	3	A	B	●	D	8	A	●	C	D	13	A	B	●	D	18	A	●	C	D
	4	A	●	C	D	9	A	B	C	●	14	A	B	C	●	19	A	B	●	D
	5	A	B	C	●	10	A	B	C	●	15	A	●	C	D	20	●	B	C	D
ANSWER 2	21	●	B	C	D	26	A	●	C	D	31	●	B	C	D	36	A	B	C	●
	22	A	B	●	D	27	●	B	C	D	32	A	●	C	D	37	A	B	C	●
	23	A	●	C	D	28	A	●	C	D	33	A	B	●	D	38	A	●	C	D
	24	●	B	C	D	29	A	B	●	D	34	A	B	C	●	39	A	B	C	●
	25	●	B	C	D	30	A	B	C	●	35	A	●	C	D	40	A	B	●	D
ANSWER 3	41	A	●	C	D	46	A	B	C	●	51	A	B	●	D	56	A	●	C	D
	42	A	●	C	D	47	A	●	C	D	52	A	●	C	D	57	●	B	C	D
	43	A	B	●	D	48	A	B	C	●	53	A	B	C	●	58*	A	B	C	D
	44	A	B	C	●	49	●	B	C	D	54*	A	B	C	D	59	●	B	C	D
	45	A	B	●	D	50	A	●	C	D	55	A	●	C	D	60	●	B	C	D

SEE PAGES 93–94 FOR MULTIPLE-CHOICE GRADING SCALES

*** Credit was given for all answers.**

PLEASE DO NOT MARK IN THIS AREA!

SERIAL NO.

(5 points)

ANSWER 4(a)

Item	Land	Building	Expense
61	●	B	E
62	L	B	●
63	L	●	E
64	●	B	E

Item	Land	Building	Expense
65	●	B	E
66	L	●	E
67	●	B	E
68	L	B	●

Answer 4(b) (5 points)

Silver, Inc.
COMPUTATION OF DOLLAR-VALUE LIFO INVENTORY
December 31, 1990 and 1991

Year	*FIFO inventory*	*Current year cost change index*	*Link-chain cost index*	*Inventory at base-year costs*
1989	$100,000	1.00	1.00	$100,000
1990	137,500	1.25	1.25	110,000
1991	195,000	1.20	1.50	130,000

Year	*LIFO inventory layers at base-year costs*	*Link-chain cost index*	*1990 dollar-value LIFO inventory*	*1991 dollar-value LIFO inventory*
1989	$100,000	1.00	$100,000	$100,000
1990	10,000	1.25	12,500	12,500
1991	20,000	1.50		30,000
	$130,000		$112,500	$142,500

Answer 5 (10 points)

a.

Powell Corp.
INCOME STATEMENT
For the Year Ended June 30, 1992

Revenues:		
Machine sales	$750,000	
Service revenues	250,000	
Interest revenue	10,000	
Total revenues		$1,010,000
Expenses:		
Cost of sales—machines	425,000	
Cost of services	100,000	
Administrative expenses	300,000	
Research and development expenses	110,000	
Interest expense	5,000	
Loss from asset disposal	40,000	
Current income tax expense	6,000	
Deferred income tax expense	4,500	
Total expenses and losses		990,500
Income before extraordinary gain		19,500
Extraordinary gain, net of income taxes of $75,000		175,000
Net income		$ 194,500
Earnings (loss) per share:		
Income before extraordinary gain		($0.40)
Net income		$0.47

b.

Net income	$194,500
Add:	
Taxes on extraordinary gain	75,000
Provision for income taxes	10,500
Financial statement income before income taxes	280,000
Permanent difference — officer's life insurance	5,000
Temporary difference — excess of tax over financial statement depreciation	(15,000)
Taxable income	$270,000

Uniform Certified Public Accountant Examination

OBJECTIVE ANSWER SHEET

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5	5	5	5	5	5	5
6	6	6	6	6	6	6
7	7	7	7	7	7	7
8	8	8	8	8	8	8
9	9	9	9	9	9	9

VERSION 1

State ______________________

ACCOUNTING PRACTICE — PART II

2

November 5, 1992: 1:30 P.M. to 6:00 P.M.

INSTRUCTIONS TO CANDIDATES

1. The objective portion of your examination will not be graded if you fail to record your answers on this *Objective Answer Sheet.* Your State Board will instruct you either to detach and turn in separately the *Objective Answer Sheet* or to leave it attached to pages 3 through 10. Follow the State Board instructions for turning in the *Objective Answer Sheet.*

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(30 points)

	#					#					#					#				
ANSWER 1	1	A	B	C	●	6	●	B	C	D	11	A	B	C	●	16	A	●	C	D
	2	●	B	C	D	7	A	●	C	D	12	●	B	C	D	17	A	B	C	●
	3	A	B	●	D	8	A	●	C	D	13	A	B	C	●	18	A	B	●	D
	4	●	B	C	D	9	A	●	C	D	14	A	B	●	D	19	A	B	●	D
	5	●	B	C	D	10	A	B	●	D	15	A	●	C	D	20	A	B	C	●
ANSWER 2	21	A	●	C	D	26	A	B	C	●	31	A	●	C	D	36	A	B	●	D
	22	●	B	C	D	27	A	●	C	D	32	A	B	C	●	37	A	B	●	D
	23	A	●	C	D	28	A	B	C	●	33	A	B	C	●	38	●	B	C	D
	24	●	B	C	D	29	●	B	C	D	34	A	●	C	D	39	A	B	●	D
	25	A	●	C	D	30	A	●	C	D	35	A	B	C	●	40	●	B	C	D
ANSWER 3	41	●	B	C	D	46	A	●	C	D	51	A	B	●	D	56	A	●	C	D
	42	A	B	●	D	47	A	B	●	D	52	A	B	●	D	57	A	B	C	●
	43	A	●	C	D	48	A	B	C	●	53	●	B	C	D	58	A	●	C	D
	44	A	●	C	D	49	●	B	C	D	54	A	B	C	●	59	A	B	●	D
	45	A	B	C	●	50	A	B	●	D	55	●	B	C	D	60	●	B	C	D

SEE PAGES 93-94 FOR MULTIPLE-CHOICE GRADING SCALES

PLEASE DO NOT MARK IN THIS AREA

SERIAL NO.

(10 points)

ANSWER 4

Item	Recording of Transactions (select one)
61	A B C D E F ● H I J K L
62	A B C D E F G H I J ● L
63	A B C D E F G H I J K ●
64	A B C D E F G H I J K ●
65	A B C D ● F G H I J K L
66	A B C D E F G H I ● K L
67	A B C ● E F G H I J K L
68	● B C D E F G H I J K L
69	A B C D E ● G H I J K L
70	A ● C D E F G H I J K L

Item	Accounting and Reporting (select one)
71	A ● C D E F G H I J
72	A B C D E ● G H I J
73	A B C ● E F G H I J
74	A B C D E F G H I ●
75	A ● C D E F G H I J
76	A B C D E F ● H I J
77	● B C D E F G H I J
78	A B C ● E F G H I J
79	A B C D E F G H ● J
80	A B C D E F G ● I J

Answer 5 (10 points)

Candidate's No. ____________________
State ____________________
Question No. 5 **Page** ____________

Dali and Conti, D/B/A
Perle Restaurant
TAX WORKSHEET
For the Year Ended December 31, 1991

	Income Statement	*Adjustments*	*Perle's Income & Deductions*	*Information for* *Perle's Schedule K*	*Dali's Schedule K-1*
Sales	900,000		900,000		
Cost of sales	360,000		360,000		
Gross profit	540,000		540,000		
Operating expenses					
Salaries and wages (excluding partners)	179,000		179,000		
Less jobs credit	(9,000)		(9,000)	9,000	4,500
Guaranteed payments to partners	100,000	8,000	100,000 8,000	100,000 8,000	50,000 4,000
Amortization of permanent liquor license	1,000	(1,000)			
Annual liquor license fee	500		500		
Depreciation	26,000	(10,000)	16,000		
Section 179 expense deduction				10,000	5,000
Partners' health insurance premiums	8,000	(8,000)			
Keogh contributions	12,500	(7,000)	5,500	7,000	3,500
Charitable contribution	50,000	(50,000) 3,000		50,000 3,000	25,000 1,500*
Total operating expenses	368,000		300,000		
Operating (ordinary) income	172,000		240,000	240,000	120,000
Other income (loss)					
Dividends	1,600	(1,600)		1,600	800
Rental	(300)	300		(300)	(150)
Other expense					
Interest on investment debt	(800)	800		(800)	(400)
Total income	172,500				

* Tax preference

Uniform Certified Public Accountant Examination

OBJECTIVE ANSWER SHEET

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5	5	5	5	5	5	5
6	6	6	6	6	6	6
7	7	7	7	7	7	7
8	8	8	8	8	8	8
9	9	9	9	9	9	9

VERSION 1

State ____________________

AUDITING

November 5, 1992: 8:30 A.M. to 12:00 NOON

A

INSTRUCTIONS TO CANDIDATES

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(60 points)

ANSWER 1

No.	A	B	C	D	No.	A	B	C	D	No.	A	B	C	D	No.	A	B	C	D
1	A	B	●	D	16	A	●	C	D	31	A	●	C	D	46	A	B	C	●
2	A	●	C	D	17	A	●	C	D	32	●	B	C	D	47	A	●	C	D
3	●	B	C	D	18	A	B	C	●	33	A	B	●	D	48	●	B	C	D
4	●	B	C	D	19	●	B	C	D	34	A	B	●	D	49	●	B	C	D
5	A	B	●	D	20	A	B	●	D	35	●	B	C	D	50	●	B	C	D
6	A	B	●	D	21	A	B	●	D	36	A	●	C	D	51	A	●	C	D
7	A	B	●	D	22	●	B	C	D	37	A	B	●	D	52	A	B	C	●
8	A	B	C	●	23	A	●	C	D	38	A	B	C	●	53	A	B	●	D
9	●	B	C	D	24	A	B	C	●	39	A	B	C	●	54	A	B	●	D
10	A	B	●	D	25	A	B	C	●	40	A	B	C	●	55	A	B	C	●
11	A	B	C	●	26	●	B	C	D	41	A	B	●	D	56	A	B	●	D
12	A	●	C	D	27	●	B	C	D	42	A	B	●	D	57	A	B	C	●
13	A	B	C	●	28	A	B	●	D	43	A	●	C	D	58	●	B	C	D
14	A	B	C	●	29	A	B	C	●	44	A	●	C	D	59	A	●	C	D
15	A	●	C	D	30	●	B	C	D	45	A	B	C	●	60	A	B	●	D

SEE PAGES 93 -94 FOR MULTIPLE-CHOICE GRADING SCALES

PLEASE DO NOT MARK IN THIS AREA

SERIAL NO.

A

(10 points)

ANSWER 3

Item	Investments (select one)
61	Ⓐ Ⓑ Ⓒ Ⓓ ● Ⓕ Ⓖ
62	Ⓐ Ⓑ Ⓒ Ⓓ Ⓔ ● Ⓖ
63	Ⓐ Ⓑ Ⓒ ● Ⓔ Ⓕ Ⓖ

Item	Accounts Receivable (select one)
64	Ⓐ ● Ⓒ Ⓓ Ⓔ Ⓕ Ⓖ
65	Ⓐ Ⓑ Ⓒ Ⓓ ● Ⓕ Ⓖ
66	Ⓐ Ⓑ ● Ⓓ Ⓔ Ⓕ Ⓖ
67	Ⓐ Ⓑ Ⓒ Ⓓ Ⓔ ● Ⓖ

Item	Property and Equipment (select one)
68	Ⓐ Ⓑ Ⓒ ● Ⓔ Ⓕ Ⓖ
69	Ⓐ Ⓑ Ⓒ Ⓓ Ⓔ Ⓕ ●
70	Ⓐ ● Ⓒ Ⓓ Ⓔ Ⓕ Ⓖ

Answer 3 (10 points)

Deficiencies in the auditors' report are as follows:

First (introductory) paragraph:

- The statement of retained earnings is not identified.
- The auditors' responsibility to express an opinion is omitted.

Second (scope) paragraph:

- The auditor obtains reasonable assurance about whether the financial statements are "free of material misstatement," not "fairly presented."
- The auditors' assessment of the accounting principles used is omitted.
- An audit provides a "reasonable basis for an opinion," not a "basis for determining whether any material modifications should be made."

Third (first explanatory) paragraph:

- An explanatory paragraph added to the report to describe a change in accounting principle (lack of consistency) should follow the opinion paragraph, not precede it.

Fourth (opinion) paragraph:

- The phrase "except for" should not be used.
- The auditor's concurrence with the change in accounting principles is implicit and should not be mentioned.
- Reference to the prior year's (1991) financial statements is omitted.

Fifth (second explanatory) paragraph:

- The fact that the outcome of the lawsuit cannot presently be estimated is omitted.
- It is inappropriate to state that "provision for any liability is subject to adjudication" because the report is ambiguous as to whether a liability has been recorded.

Answer 4 (10 points)

a. In planning an audit, an auditor's understanding of the internal control structure elements should be used to identify the types of potential misstatements that could occur, to consider the factors affecting the risk of material misstatement, and to influence the design of substantive tests.

b. An auditor obtains an understanding of the design of relevant internal control structure policies and procedures and whether they have been placed in operation. Assessing control risk at below the maximum level further involves identifying specific policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions. It also involves performing tests of controls to evaluate the operating design and effectiveness of such policies and procedures.

c. When seeking a further reduction in the assessed level of control risk, an auditor should consider whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter.

d. An auditor should document the understanding of an entity's internal control structure elements obtained to plan the audit. The auditor also should document the basis for the auditor's conclusion about the assessed level of control risk. If control risk is assessed at the maximum level, the auditor should document that conclusion, but is not required to document the basis for that conclusion. However, if the assessed level of control risk is below the maximum level, the auditor should document the basis for the conclusion that the effectiveness of the design and operation of internal control structure policies and procedures supports that assessed level.

Answer 5 (10 points)

a. Before applying principal substantive tests to balance sheet accounts at April 30, 1993, the interim date, Cook should assess the difficulty in controlling incremental audit risk. Cook should consider whether

- Cook's experience with the reliability of the accounting records and management's integrity has been good;
- Rapidly changing business conditions or circumstances may predispose General's management to misstate the financial statements in the remaining period;
- The year-end balances of accounts selected for interim testing will be predictable;
- General's procedures for analyzing and adjusting its interim balances and for establishing proper accounting cutoffs will be appropriate;
- General's accounting system will provide sufficient information about year-end balances and transactions in the final two months of the year to permit investigation of unusual transactions, significant fluctuations, and changes in balance compositions that may occur between the interim and balance sheet dates;
- The cost of the substantive tests necessary to cover the final two months of the year and provide the appropriate audit assurance at year end is substantial.

Assessing control risk at below the maximum would not be required to extend the audit conclusions from the interim date to the year end; however, if Cook assesses control risk at the maximum during the final two months, Cook should consider whether the effectiveness of the substantive tests to cover that period will be impaired.

b. Cook should design the substantive tests so that the assurance from those tests and the tests to be applied as of the interim date, and any assurance provided from the assessed level of control risk, achieve the audit objectives at year end. Such tests should include the comparison of year-end information with comparable interim information to identify and investigate unusual amounts. Other analytical procedures and/or substantive tests should be performed to extend Cook's conclusions relative to the assertions tested at the interim date to the balance sheet date.

Uniform Certified Public Accountant Examination

OBJECTIVE ANSWER SHEET

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4	4	4	4	4	4	4
5	5	5	5	5	5	5
6	6	6	6	6	6	6
7	7	7	7	7	7	7
8	8	8	8	8	8	8
9	9	9	9	9	9	9

VERSION 1

State ______________________

BUSINESS LAW

November 6, 1992: 8:30 A.M. to 12:00 NOON

L

INSTRUCTIONS TO CANDIDATES

1. The objective portion of your examination will not be graded if you fail to record your answers on this *Objective Answer Sheet.* Your State Board will instruct you either to detach and turn in separately the *Objective Answer Sheet* or to leave it attached to pages 3 through 14. Follow the State Board instructions for turning in the *Objective Answer Sheet.*

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(60 points)

ANSWER 1

1	●	B	C	D	16	A	B	C	●	31	●	B	C	D	46	A	B	C	●
2	●	B	C	D	17	A	B	C	●	32	A	B	C	●	47	A	B	C	●
3	●	B	C	D	18	A	B	●	D	33	A	●	C	D	48	●	B	C	D
4	●	B	C	D	19	A	B	C	●	34	●	B	C	D	49	A	●	C	D
5	A	●	C	D	20	A	●	C	D	35	A	B	●	D	50	●	B	C	D
6	A	B	●	D	21	A	B	●	D	36	A	B	C	●	51	A	B	●	D
7	A	●	C	D	22	A	B	●	D	37	A	●	C	D	52	●	B	C	D
8	●	B	C	D	23	A	B	●	D	38	A	B	C	●	53	A	B	C	●
9	A	B	C	●	24	●	B	C	D	39	A	B	●	D	54	A	B	●	D
10	A	●	C	D	25	●	B	C	D	40	A	B	C	●	55	A	B	●	D
11	A	●	C	D	26	A	●	C	D	41	A	B	C	●	56	A	B	C	●
12	A	●	C	D	27	A	●	C	D	42	●	B	C	D	57	A	B	C	●
13	A	B	●	D	28	A	B	●	D	43	A	B	C	●	58	A	B	C	●
14	●	B	C	D	29	●	B	C	D	44	A	●	C	D	59	A	●	C	D
15	A	B	●	D	30	●	B	C	D	45	A	●	C	D	60	A	B	●	D

SEE PAGES 93-94 FOR MULTIPLE-CHOICE GRADING SCALES

PLEASE DO NOT MARK IN THIS AREA! **SERIAL NO.**

(10 points)

ANSWER 2

Item	Yes	No	Item	Yes	No	Item	Yes	No
61	●	(N)	66	●	(N)	71	(Y)	●
62	(Y)	●	67	●	(N)	72	●	(N)
63	(Y)	●	68	●	(N)	73	(Y)	●
64	●	(N)	69	●	(N)	74	(Y)	●
65	●	(N)	70	(Y)	●	75	●	(N)

Answer 3 (10 points)

a. 1. Union Bank will be successful in its negligence suit against Weaver. To be successful in a lawsuit for accountant's negligence there must be:

- duty
- breach
- plaintiff must be a known intended user
- reliance
- loss

Weaver was negligent in performing the audit by failing to confirm accounts receivable, which resulted in failing to discover the overstatement of accounts receivable. Weaver's failure to confirm accounts receivable was a violation of Weaver's duty to comply with generally accepted auditing standards. Weaver knew that Union would receive the financial statements and was thereby an intended user. Union relied on Weaver's opinion in granting the loan and, as a result, suffered a loss.

2. Union will be successful in its common-law fraud suit against Weaver. To be successful in a lawsuit for common law fraud there must be:

- an intentional material misstatement or omission
- reliance
- loss

Weaver was grossly negligent for failing to qualify its opinion after being advised of Butler's potential material losses from the product liability lawsuit by legal counsel. Weaver will be liable to anyone who relied on Weaver's opinion and suffered a loss as a result of this fraudulent omission.

b. Butler's stockholders who purchased stock under the 1990 offerings will also be successful in their suit against Weaver under Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Under the Act stock purchaser must show:

- intentional material misstatement or omission (scienter)
- reliance
- loss

Weaver's failure to qualify its opinion for Butler's potential legal liability was material and done intentionally (scienter). Weaver will be liable for losses sustained by the purchasers who relied on Weaver's opinion.

Answer 4 (10 points)

a. Exotic's first position is incorrect. Although Peterson lacked actual authority to bind Exotic to the Creatures contract, from Creatures' perspective Peterson did have apparent authority to do so. Peterson was a store manager and had previously contracted with Creatures on Exotic's behalf. Creatures would not be bound by the limitation on Peterson's authority unless Creatures was aware of it.

Exotic's second position is incorrect. Although Peterson did not have express authority to charge purchases at Handy Hardware. Peterson had the implied authority as store manager to enter into contracts incidental to the express grant of authority to act as manager. Buying paint and brushes to improve Exotic's store would fall within Peterson's implied grant of authority.

Exotic's third position is correct. An agent owes a duty of loyalty to his or her principal. An agent may not benefit directly or indirectly from an agency relationship at the principal's expense. If an agent receives any profits from the principal/agent relationship without the consent of the principal, the agent must pay the profits to the principal. In this case, Peterson's incentive payments constituted a violation of Peterson's fiduciary duty to Exotic. Peterson must turn over all incentive payments to Exotic.

b. Peterson was negligent by allowing Mathews to handle a ferret that Peterson knew was dangerous. An employer is held liable for the torts of its employees if the tort occurs within the scope of employment and if the employee is subject to the employer's control. At the time of the accident, Peterson was acting within the scope of employment and subject to Exotic's control because this conduct occurred while on the job, during normal working hours, and with the intention of benefitting Exotic. Exotic, therefore, will be liable to Mathews because the accident occurred within the scope of Peterson's employment.

Peterson also will be liable to Mathews because all persons are liable for their own negligence.

Answer 5 (10 points)

a. Rapid's claim is incorrect. Both Debco and Rapid are merchants under the UCC because they both deal in the type of goods involved in the transaction (computers).

The UCC provides that a confirmation satisfies the UCC Statute of Frauds, if an oral contract between merchants is:

- Confirmed in writing within a reasonable period of time, and
- The confirmation is signed by the party sending it and received by the other party

Both parties are bound even though the party receiving the confirmation fails to sign it. This is correct unless the party receiving the confirmation submits a written objection within 10 days of receipt. Rapid will be bound even though it did not sign the confirmation because no written objection was made.

b. Debco's first claim, that its October 25 correspondence prevented the formation of a contract, is incorrect. Debco's October 12 purchase order will be regarded as a firm offer under the UCC because:

- Debco is a merchant.
- The purchase order is in writing and signed.
- The purchase order states that it will not be withdrawn for the time specified.

Because Debco's October 12 purchase order is considered a firm offer, Debco cannot revoke it, and its October 25 attempt to do so is ineffective.

Debco's second claim, that TMI's October 31 correspondence is not an effective acceptance because it was not received until November 3, is incorrect. An acceptance of an offer is effective when dispatched (in this case, when mailed), provided that an appropriate mode of communication is used. The UCC provides that an offer shall be construed as inviting acceptance in any manner and by any medium reasonable in the circumstances. In this case, Debco made its offer by mail, which, if adequately addressed with proper postage affixed, would be considered a reasonable manner and medium for acceptance. As a result, TMI's acceptance *was effective* when mailed on October 31.

Debco's third claim, that TMI's acceptance is not effective because it added payment terms to Debco's offer, is also incorrect. The UCC provides that a definite and timely expression of acceptance of an offer will form a contract, even if the terms of the acceptance are different from those in the offer, unless acceptance is expressly made conditional on accepting the different terms. Therefore, TMI's October 31 correspondence, which expressly stated that TMI would ship the computers ordered by Debco, was an effective acceptance, and a contract was formed despite the fact that TMI added payment terms.

Uniform Certified Public Accountant Examination

OBJECTIVE ANSWER SHEET

IMPORTANT INSTRUCTIONS

- Use a NO. 2 PENCIL only.
- Make heavy black marks that fill the oval completely.
- Erase clearly any marks you wish to change.
- Make no stray marks on this sheet.
- It is to your advantage to answer all questions.

INCORRECT MARKS CORRECT MARK

Record your 7-digit candidate number in the boxes.

In each column blacken completely the oval for each digit you have recorded.

CANDIDATE NUMBER

0	0	0	0	0	0	0
1	1	1	1	1	1	1
2	2	2	2	2	2	2
3	3	3	3	3	3	3
4	4	4	4	4	4	4
5	5	5	5	5	5	5
6	6	6	6	6	6	6
7	7	7	7	7	7	7
8	8	8	8	8	8	8
9	9	9	9	9	9	9

VERSION 1

State ____________________

ACCOUNTING THEORY

November 6, 1992: 1:30 P.M. to 5:00 P.M.

T

INSTRUCTIONS TO CANDIDATES

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(60 points)

ANSWER 1

1	A	B	●	D	16	●	B	C	D	31	A	●	C	D	46	A	B	●	D
2	●	B	C	D	17	A	●	C	D	32	A	B	C	●	47	●	B	C	D
3	A	B	C	●	18	A	●	C	D	33	●	B	C	D	48	A	●	C	D
4	A	●	C	D	19	A	B	C	●	34	A	●	C	D	49	A	B	●	D
5	●	B	C	D	20	●	B	C	D	35	●	B	C	D	50	A	B	●	D
6	A	●	C	D	21	A	B	C	●	36	A	B	C	●	51	A	B	C	●
7	A	●	C	D	22	A	B	●	D	37	A	B	●	D	52	A	B	●	D
8	A	●	C	D	23	A	B	●	D	38	A	●	C	D	53	A	B	C	●
9	A	B	●	D	24	A	B	C	●	39	A	●	C	D	54	A	●	C	D
10	●	B	C	D	25	A	B	●	D	40	●	B	C	D	55	A	B	C	●
11	A	B	●	D	26	A	B	C	●	41	A	B	C	●	56	A	B	C	●
12	A	B	C	●	27	A	●	C	D	42	●	B	C	D	57	●	B	C	D
13	●	B	C	D	28	A	●	C	D	43	A	B	C	●	58	A	B	●	D
14	A	B	C	●	29	●	B	C	D	44	●	B	C	D	59	●	B	C	D
15	A	B	●	D	30	●	B	C	D	45	A	B	C	●	60	A	●	C	D

SEE PAGES 93–94 FOR MULTIPLE-CHOICE GRADING SCALES

PLEASE DO NOT MARK IN THIS AREA

SERIAL NO.

ACCOUNTING THEORY

T

(10 points)

ANSWER 2

Item	Financial Statement Categories (select one)				
61	A	●	C	D	E
62	A	B	C	●	E
63	A	B	C	D	●
64	A	●	C	D	E
65	A	B	C	●	E
66	A	B	●	D	E
67	A	B	C	D	●
68	A	●	C	D	E

Item	Line End Points (select two)							
69	A	●	C	●	E	F	G	O
70	A	B	C	●	●	F	G	O
71	●	B	●	D	E	F	G	O
72	●	●	C	D	E	F	G	O
73	A	B	C	D	E	F	●	●

Answer 3 (10 points)

a. The purpose of the effective interest method is to provide periodic interest expense based on a constant rate over the life of the bonds. The impact of applying the effective interest method on Corval's bond premium is to decrease the premium by a lesser amount in 1988 compared to using the straight-line method of amortization.

b. Under the straight-line interest method, the premium is amortized at a constant periodic amount, and in 1988 the premium amortization would have been greater than amortization under the effective interest method. Consequently, for 1988, interest expense would have been understated, net income would have been overstated, and the carrying amount ot the bonds would have been understated.

c. The November 30, 1991, transaction is reported as an extraordinary loss after income from continuing operations. This loss equals the excess of the fair value of the cash and property transferred over the bonds' carrying amount on November 30, 1991. This presentation is appropriate because this is an early extinguishment of debt.

d. The gross amount of the extraordinary loss is added to net income under cash flows from operating activities. The cash payment is reported as a cash outflow from financing activities.

Corval should disclose details of the noncash elements of the transaction either on the same page as the statement of cash flows or in the notes to the financial statements.

Answer 4 (10 points)

a. A change from the LIFO inventory method to the FIFO inventory method is a change in accounting principle. Windsor should restate the 1990 financial statements, including adjustment for the effect on January 1, 1990, retained earnings, as if the FIFO method had been adopted at the beginning of 1990. The nature and justification for the change in inventory method should be disclosed in the notes to the 1991 financial statements. The effects of the change on income statement components should be disclosed for all periods presented.

b. Windsor's change from sum-of-the-years' digits depreciation method for all future machinery acquisitions is a change in accounting principle. The nature and justification for the change in depreciation methods should be disclosed in the notes to the 1991 comparative financial statements. The 1990 financial statements are unaffected by the change, but the effects of the change on 1991 income components should be disclosed.

c. A change from the cash basis of vacation pay expense recognition to the accrual basis is a change from an accounting principle that is not generally accepted to one that is generally accepted. Such a change is considered an error correction. Windsor should restate the 1990 financial statements, including adjustment for the effect on January 1, 1990, retained earnings, to correct prior errors. Windsor should disclose the nature and details of the corrections in notes to the 1991 financial statements.

Answer 5 (10 points)

a. 1. When the old engines' costs are known, the snowmobiles account is decreased by the old engines' costs, and accumulated depreciation is decreased by the accumulated depreciation on the old engines. A current asset would be recorded for the fair value of the future repair and maintenance services. The net difference between the old engines' carrying amounts and their fair values is recorded as an operating gain or loss. To record the new engines' acquisition, both the snowmobiles account and accounts payable are increased by the new engines' costs.

2. If the old engines' costs are unknown then either the snowmobiles account would be increased or accumulated depreciation would be decreased by the difference between the new engines' costs and the old engines' fair values.

b. 1. Assumptions underlying use of an accelerated depreciation method include:

- An asset is more productive in the earlier years of its estimated useful life. Therefore, greater depreciation charges in the earlier years would be matched against the greater revenues generated in the earlier years.
- Repair and maintenance costs are often higher in later periods and an accelerated depreciation method results in a more nearly annual constant total cost over the years of use.
- An asset may become obsolete before the end of its originally estimated useful life. The risk associated with estimated long-term cash flows is greater than the risk associated with near-term cash flows. Accelerated depreciation recognizes this condition.

2. Winter should calculate snowmobile depreciation by applying twice the straight-line rate to their carrying amounts.

c. Under the inventory (appraisal) method, Winter calculates the ending undepreciated cost on the skis, poles, and boots by multiplying the physical quantities of these items on hand by an appraised amount. This ending undepreciated cost is classified as a noncurrent asset. Depreciation included in continuing operations equals the sum of the beginning balance and purchases for the year less the ending undepreciated cost.

Multiple-Choice Grading Scales

Accounting Practice — Part I

The scores for the multiple-choice questions were determined in accordance with the following scales:

Answer 1 (10 points)

C	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
S	0	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10	10

Answer 2 (10 points)

C	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
S	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 3 (10 points)

C	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
S	0	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10	10

Accounting Practice — Part II

The scores for the multiple-choice questions were determined in accordance with the following scales:

Answer 1 (10 points)

C	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
S	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 2 (10 points)

C	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
S	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 3 (10 points)

C	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
S	0	1	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10

C = Number of correct responses.
S = Score for the number of correct responses.

Multiple-Choice Grading Scales

Auditing

The scores for the multiple-choice questions were determined in accordance with the following scales:

Answer 1 (60 points)

C	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
S	0	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21

C	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
S	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41

C	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
S	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60

Business Law

The scores for the multiple-choice questions were determined in accordance with the following scales:

Answer 1 (60 points)

C	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
S	0	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25

C	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
S	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45

C	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
S	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60

Accounting Theory

The scores for the multiple-choice questions were determined in accordance with the following scales:

Answer 1 (60 points)

C	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
S	0	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28

C	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
S	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46	47	48

C	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
S	49	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60	60	60	60

C = Number of correct responses.
S = Score for the number of correct responses.

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November 1992

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Auditing

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INDEX – QUESTIONS

HOW TO USE THIS INDEX: This index presents examination question number references for the four sections of the CPA examination – Accounting Practice Parts I and II, Auditing, Business Law, and Accounting Theory. Each examination section has been organized according to its content specification outline, with questions indexed according to the areas and groups tested.

The question references listed in the right-hand column are designated as follows: The question numbers for the Accounting Practice section are followed by I for Part I and II for Part II. The letter M following question numbers indicates a multiple choice item. The letter F following question numbers indicates an other objective answer format item. For example, the reference 17M-I means multiple choice item number 17 for Accounting Practice Part I; the reference 61F-I means other objective answer format item number 61 for Accounting Practice Part I; and the reference 5-I means problem number 5 for Accounting Practice Part I. For the Auditing, Business Law, and Accounting Theory sections, absence of the letter M or the letter F indicates an essay question number.*

Accounting Practice — Content Specification Outline

* N-numbers in parentheses (i.e., N-2) represent page numbers in the November 1992 Uniform CPA Examination.

Accounting Practice — Content Specification Outline (cont.)

Accounting Practice — Content Specification Outline (cont.)

Auditing — Content Specification Outline

Business Law — Content Specification Outline

Accounting Theory — Content Specification Outline

Accounting Theory — Content Specification Outline (cont.)

VI. Other Financial Topics.

VII. Cost Accumulation, Planning, and Control.

VIII. Not-for-Profit and Governmental Accounting.

CONTRIBUTOR TO THIS UNIFORM CPA EXAMINATION

The Board of Examiners expresses its gratitude to the following contributor of a question appearing in the November 1992 examination.

*THOMAS J. SCHULTZ

* Question submitted while a student of Professor Walter F. James, Washburn University of Topeka.

FUTURE CPA EXAMINATION DATES

1993 — May 5, 6, 7
November 3, 4, 5
1994 — May 4, 5
November 2, 3
1995 — May 3, 4
November 1, 2
1996 — May 8, 9
November 6, 7
1997 — May 7, 8
November 5, 6

1998 — May 6, 7
November 4, 5
1999 — May 5, 6
November 3, 4
2000 — May 3, 4
November 1, 2
2001 — May 2, 3
November 7, 8

2002 — May 8, 9
November 6, 7
2003 — May 7, 8
November 5, 6
2004 — May 5, 6
November 3, 4
2005 — May 4, 5
November 2, 3

Beginning with the May 1994 Examination, the Examination testing time will be shortened to two days.

CONTENT SPECIFICATION OUTLINES

Content Specification Outlines

The original content specification outlines were adopted by the Board of Examiners in 1981, effective for the November 1983 examination. In 1984 the Board of Examiners modified the original content specification outlines in order to incorporate the information obtained from an AICPA practice analysis study.

The practice analysis study documented the major work segments performed by certified public accountants in the practice of public accountancy and identified the knowledge, skills, and abilities necessary to perform those work segments. These content specification outlines, effective for the May 1989 Uniform CPA Examination, are based upon the results of the practice analysis study.

The content specification outlines in this Appendix are effective through the November 1993 examination. Beginning in May 1994, the examination will be restructured into four new sections, and in December 1993 a new edition of *Information for CPA Candidates* will incorporate the new content specification outlines.

Meaning and Use of Content Specification Outlines

The content specification outlines are divided into three levels—areas, groups, and topics, with the following outline notations:

- Areas by Roman numerals (I. Area)
- Groups by capital letters (A. Group)
- Topics by Arabic numbers (1. Topic)

The content specification outlines list the areas, groups, and topics to be tested, and also indicate the approximate percentage of the total test score devoted to each areas. Some of the uses of the outlines will be—

- To assure consistent subject-matter coverage from one examination to the next.
- To assist candidates in preparing for the examination by indicating subjects which may be covered by the examination.
- To provide guidance to those who are responsible for preparing the examination in order to assure a balanced examination.
- To alert accounting educators about the subject matter considered necessary to prepare for the examination.

The relative weight given to each area is indicated by its approximate percentage allocation. The examination will sample from the groups and topics listed within each area in order to meet the approximate percentage allocation. Generally, the group title should be sufficient to indicate the subject matter to be covered. However, in certain instances, topics have been explicitly listed in order to clarify or limit the subject matter covered within a group.

No weight allocation is given for groups or topics. For example, if there are several groups within an area or several topics within a group, no inference should be drawn about the relative importance or weight to be given to these groups or topics on an examination.

Clear-cut distinctions about subject matter do not always exist. Thus, there may be overlapping of subjects in the four sections of the examination. For example, Auditing questions often require a knowledge of accounting theory and practice, as well as of auditing procedures. Also, Business Law questions may be set in an accounting or auditing environment, and answers may involve integration with accounting and auditing knowledge.

The content specification outlines are considered to be complete in respect to the subjects to be tested on an examination, including recent professional developments as they affect these subjects. Candidates should answer examination questions, developed from these outlines, in terms of the most recent developments, pronouncements, and standards in the accounting profession. When new subject matter is identified, the outlines will be amended to include it and this will be communicated to the profession.

Accounting Practice Section

The Accounting Practice section tests the candidates' ability to apply current conceptual accounting knowledge. The section includes the following: financial accounting concepts relating to financial reports, assets, liabilities, equity, income and expense, and other financial topics; cost/managerial accounting concepts of cost accumulation, planning, and control; not-for-profit and governmental accounting; and federal taxation.

In preparing for this section, candidates should study the pronouncements of the Financial Accounting Standards Board, Governmental Accounting Standards Board, Internal Revenue Code, Federal Tax Regulations, accounting textbooks, AICPA Audit and Accounting Guides, and other literature pertaining to accounting.

Accounting Practice—Content Specification Outline

I. Presentation of Financial Statements or Worksheets (15 percent)

 A. Balance Sheet
 B. Income Statement
 C. Statement of Cash Flows
 D. Statement of Owners' Equity
 E. Consolidated Financial Statements or Worksheets

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles (10 percent)

 A. Cash, Marketable Securities, and Investments

  1. Cash
  2. Marketable Equity Securities
  3. Other Securities
  4. Investment in Bonds
  5. Investment in Stocks
  6. Sinking and Other Funds

 B. Receivables and Accruals

  1. Accounts and Notes Receivable
  2. Affiliated Company Receivables
  3. Discounting of Notes
  4. Installment Accounts
  5. Interest and Other Accrued Income
  6. Allowance for Uncollectible Accounts

 C. Inventories

  1. Acquisition Costs
  2. Costing Methods
  3. Valuation Methods

 D. Property, Plant, and Equipment Owned or Leased

  1. Acquisition Costs
  2. Capital Versus Revenue Expenditures
  3. Depreciation, Amortization, and Depletion
  4. Leasehold Improvements
  5. Obsolescence and Write-downs
  6. Disposition

 E. Intangibles and Other Assets

  1. Goodwill
  2. Patents

3. Other Intangibles
4. Prepaid Expenses
5. Deferred Income Tax Assets
6. Pension Cost

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles (10 percent)

A. Payables and Accruals

1. Accounts Payable
2. Notes Payable
3. Accrued Employees' Costs
4. Interest and Other Accrued Expenses
5. Unfunded Accrued Pension Cost
6. Taxes Payable
7. Deposits and Escrows

B. Deferred Revenues

1. Unperformed Service Contracts
2. Subscriptions or Tickets Outstanding
3. Installment Sales
4. Sale and Leaseback

C. Deferred Income Tax Liabilities

1. Equity Method of Accounting for Investments
2. Depreciation of Plant Assets
3. Long-Term Construction Contracts
4. Other Temporary Differences

D. Capitalized Lease Liability

1. Measurement at Present Value
2. Amortization

E. Bonds Payable

1. Issue of Bonds
2. Issue Costs
3. Amortization of Discount or Premium
4. Types of Bonds
5. Conversion of Bonds
6. Detachable Stock Warrants
7. Retirement of Bonds

F. Contingent Liabilities and Commitments

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles (5 percent)

A. Preferred and Common Stock

1. Issued
2. Outstanding
3. Retirement of Stock
4. Book Value Per Share
5. Classification

B. Additional Paid-in Capital

C. Retained Earnings and Dividends

1. Prior Period Adjustments
2. Net Income
3. Cash Dividends
4. Property Dividends
5. Liquidating Dividends
6. Stock Dividends and Splits
7. Appropriations of Retained Earnings

D. Treasury Stock and Other Contra Accounts

1. Cost Method
2. Par Value Method
3. Restrictions on Acquisition of Treasury Stock
4. Other Contra Accounts

E. Stock Options, Warrants, and Rights

F. Reorganization and Change In Entity

1. Incorporation of an Unincorporated Enterprise
2. Business Combinations
3. Bankruptcy

G. Partnerships

1. Formation
2. Admission, Retirement, and Dissolution
3. Profit and Loss Distribution and Other Special Allocations

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles (15 percent)

A. Revenues and Gains

1. Cash Versus Accrual Basis
2. At Time of Sale
3. At Completion of Production
4. During Production (percentage of completion)
5. Installment Method or Cost Recovery
6. Equity in Earnings of Investee
7. Interest
8. Dividends
9. Royalties
10. Rent
11. Disposal of Assets and Liquidation of Liabilities
12. Foreign Exchange
13. Unusual Gains

B. Expenses and Losses

1. Cost of Sales
2. General and Administrative
3. Selling
4. Financial (interest)
5. Depreciation, Amortization, and Depletion
6. Research and Development
7. Foreign Exchange
8. Uncollectible Accounts
9. Royalties
10. Rent
11. Compensation
12. Disposal of Assets and Liquidation of Liabilities
13. Unusual Losses

C. **Provision for Income Tax**

1. **Current**
2. **Deferred**

D. **Recurring Versus Nonrecurring Transactions and Events**

1. **Discontinued Operations**
2. **Extraordinary Items**

E. **Accounting Changes**
F. **Earnings Per Share**

VI. **Other Financial Topics (5 percent)**

A. Disclosures in Notes to the Financial Statements
B. ~~Accounting Policies~~ (deleted)
C. Nonmonetary Transactions
D. Interim Financial Statements
E. Historical Cost, Constant Dollar Accounting, and Current Cost
F. Gain Contingencies
G. Segments and Lines of Business
H. Employee Benefits
I. Analysis of Financial Statements
J. Development Stage Enterprises
K. Personal Financial Statements
L. Combined Financial Statements

VII. **Cost Accumulation, Planning, and Control (10 percent)**

A. **Nature of Cost Elements**

1. **Direct Materials**
2. **Direct Labor**
3. **Overhead**

B. **Process and Job Order Costing**
C. **Standard Costing**
D. **Joint and By-Product Costing, Spoilage, Waste, and Scrap**
E. **Absorption and Variable Costing**
F. **Budgeting and Flexible Budgeting**
G. **Breakeven and Cost-Volume-Profit Analysis**
H. **Capital Budgeting Techniques**

1. **Net Present Value**
2. **Internal Rate of Return**
3. **Payback Period**
4. **Accounting Rate of Return**

I. **Performance Analysis**

1. **Return on Investment**
2. **Residual Income**
3. **Controllable Revenue and Costs**

J. **Other**

1. **Regression and Correlation Analysis**
2. **Economic Order Quantity**
3. **Probability Analysis**
4. **Variance Analysis**
5. **Differential Cost Analysis**
6. **Product Pricing**

VIII. Not-for-Profit and Governmental Accounting (10 percent)

A. Fund Accounting

1. Fund Balance
2. Estimated Revenues
3. Appropriations
4. Encumbrances
5. Fund Balance Reserved for Encumbrances
6. Revenues
7. Expenditures

B. Types of Funds and Account Groups

1. General Fund
2. Special Revenue Funds
3. Debt Service Funds
4. Capital Projects Funds
5. Enterprise Funds
6. Internal Service Funds
7. Trust and Agency Funds
8. General Fixed Assets Account Group
9. General Long-Term Debt Account Group
10. Endowment and Quasi-Endowment Funds
11. Restricted and Unrestricted Funds
12. Property Funds

C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations
D. Various Types of Not-for-Profit and Governmental Organizations

1. Local and State Governments
2. Educational Institutions
3. Hospitals
4. Charitable, Religious, and Other Organizations

IX. Federal Taxation—Individuals, Estates, and Trusts (10 percent)

A. Inclusions for Gross Income and Adjusted Gross Income

1. Reporting Basis of Taxpayer—Cash, Accrual, or Modified
2. Compensation for Services
3. Business Income
4. Interest
5. Rent and Royalties
6. Dividends
7. Alimony
8. Capital Gains and Losses
9. Miscellaneous Income

B. Exclusions and Adjustments to Arrive at Adjusted Gross Income
C. Gain or Loss on Property Transactions

1. Character
2. Recognition
3. Basis and Holding Period

D. Deductions from Adjusted Gross Income
E. Filing Status and Exemptions
F. Tax Computations and Credits
G. Statute of Limitations

1. Claims for Refund
2. Assessments

H. Estate and Gift Taxation and Income Taxation of Estates and Trusts

X. Federal Taxation—Corporations, Partnerships, and Exempt Organizations (10 percent)

Corporations

A. Determination of Taxable Income or Loss

1. Determination of Gross Income, Including Capital Gains and Losses
2. Deductions from Gross Income
3. Reconciliation of Taxable Income and Book Income
4. Reconciliation of Opening and Closing Retained Earnings
5. Consolidations

B. Tax Computations and Credits
C. S Corporations
D. Personal Holding Companies
E. Accumulated Earnings Tax
F. Distributions
G. Tax-Free Incorporation
H. Reorganizations
I. Liquidations and Dissolutions

Partnerships

J. Formation of Partnership

1. Contribution of Capital
2. Contribution of Services

K. Basis of Partner's Interest

1. Acquired Through Contribution
2. Interest Acquired From Another Partner
3. Holding Period of Partner's Interest
4. Adjustments to Basis of Partner's Interest

L. Determination of Partner's Taxable Income and Partner's Elections
M. Accounting Periods of Partnership and Partners
N. Partner Dealing With Own Partnership

1. Sales and Exchanges
2. Guaranteed Payments

O. Treatment of Liabilities
P. Distribution of Partnership Assets

1. Current Distributions
2. Distributions in Complete Liquidation
3. Basis of Distributed Property

Q. Termination of Partnership

1. Change in Membership
2. Merger or Split-up of Partnership
3. Sale or Exchange of Partnership Interest
4. Payments to a Retiring Partner
5. Payments to a Deceased Partner's Successor

Exempt Organizations

R. Types of Organizations
S. Requirements for Exemption
T. Unrelated Business Income

Accounting Theory Section

The Accounting Theory section tests the candidates' conceptual knowledge of accounting. This knowledge includes a rather wide assortment of ideas variously described as assumptions, axioms, standards, postulates, conventions, principles, rules, and objectives. Ideas that have received substantial authoritative support are referred to as generally accepted accounting principles. The section includes the following: financial accounting concepts relating to general principles, assets, liabilities, equity, income and expense, and other financial topics; cost/managerial accounting concepts of cost accumulation, planning, and control; and not-for-profit and governmental accounting.

In preparing for this section, candidates should study the pronouncements of the Financial Accounting Standards Board, Governmental Accounting Standards Board, accounting textbooks, AICPA Audit and Accounting Guides, and other literature pertaining to accounting. Answers should be in accord with current accounting theory and not necessarily with accounting methods and practices promulgated by governmental agencies, such as the Internal Revenue Service and the Securities and Exchange Commission (unless these methods and practices are specifically required or are vital to a complete discussion of the issues involved).

Accounting Theory—Content Specification Outline

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards (15 percent)

A. Authority of Pronouncements (substantial authoritative support—GAAP)
B. Conceptual Framework
C. Basic Concepts and Accounting Principles
D. Nature and Purpose of Basic Financial Statements
E. Consolidated Financial Statements
F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles (15 percent)

A. Cash, Marketable Securities, and Investments

1. Cash
2. Marketable Equity Securities
3. Other Securities
4. Investment in Bonds
5. Investment in Stocks
6. Sinking and Other Funds

B. Receivables and Accruals

1. Accounts and Notes Receivable
2. Affiliated Company Receivables
3. Discounting of Notes
4. Installment Accounts
5. Interest and Other Accrued Income
6. Allowance for Uncollectible Accounts

C. Inventories

1. Acquisition Costs
2. Costing Methods
3. Valuation Methods

D. Property, Plant, and Equipment Owned or Leased

1. Acquisition Costs
2. Capital Versus Revenue Expenditures
3. Depreciation, Amortization, and Depletion
4. Leasehold Improvements
5. Obsolescence and Write-downs
6. Disposition

E. Intangibles and Other Assets

1. Goodwill
2. Patents
3. Other Intangibles
4. Prepaid Expenses
5. Deferred Income Tax Assets
6. Pension Cost

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles (10 percent)

A. Payables and Accruals

1. Accounts Payable
2. Notes Payable
3. Accrued Employees' Costs
4. Interest and Other Accrued Expenses
5. Unfunded Accrued Pension Cost
6. Taxes Payable
7. Deposits and Escrows

B. Deferred Revenues

1. Unperformed Service Contracts
2. Subscriptions or Tickets Outstanding
3. Installment Sales
4. Sale and Leaseback

C. Deferred Income Tax Liabilities

1. Equity Method of Accounting for Investments
2. Depreciation of Plant Assets
3. Long-Term Construction Contracts
4. Other Temporary Differences

D. Capitalized Lease Liability

1. Measurement at Present Value
2. Amortization

E. Bonds Payable

1. Issue of Bonds
2. Issue Costs
3. Amortization of Discount or Premium
4. Types of Bonds
5. Conversion of Bonds
6. Detachable Stock Warrants
7. Retirement of Bonds

F. Contingent Liabilities and Commitments

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles (5 percent)

A. Preferred and Common Stock

1. Issued
2. Outstanding
3. Retirement of Stock
4. Book Value Per Share
5. Classification

B. Additional Paid-in Capital

C. Retained Earnings and Dividends

1. Prior Period Adjustments
2. Net Income
3. Cash Dividends
4. Property Dividends
5. Liquidating Dividends
6. Stock Dividends and Splits
7. Appropriations of Retained Earnings

D. Treasury Stock and Other Contra Accounts

1. Cost Method
2. Par Value Method
3. Restrictions on Acquisition of Treasury Stock
4. Other Contra Accounts

E. Stock Options, Warrants, and Rights

F. Reorganization and Change in Entity

1. Incorporation of an Unincorporated Enterprise
2. Business Combinations
3. Bankruptcy

G. Partnerships

1. Formation
2. Admission, Retirement, and Dissolution
3. Profit or Loss Distribution and Other Special Allocations

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles (20 percent)

A. Revenues and Gains

1. Cash Versus Accrual Basis
2. At Time of Sale
3. At Completion of Production
4. During Production (percentage of completion)
5. Installment Method or Cost Recovery
6. Equity in Earnings of Investee
7. Interest
8. Dividends
9. Royalties
10. Rent
11. Disposal of Assets and Liquidation of Liabilities
12. Foreign Exchange
13. Unusual Gains

B. Expenses and Losses

1. Cost of Sales
2. General and Administrative

3. Selling
4. Financial (interest)
5. Depreciation, Amortization, and Depletion
6. Research and Development
7. Foreign Exchange
8. Uncollectible Accounts
9. Royalties
10. Rent
11. Compensation
12. Disposal of Assets and Liquidation of Liabilities
13. Unusual Losses

C. Provision for Income Tax

1. Current
2. Deferred

D. Recurring Versus Nonrecurring Transactions and Events

1. Discontinued Operations
2. Extraordinary Items

E. Accounting Changes
F. Earnings Per Share

VI. Other Financial Topics (15 percent)

A. Statement of Cash Flows
B. Accounting Policies
C. Accounting Changes
D. Nonmonetary Transactions
E. Business Combinations
F. Interim Financial Statements
G. Gain Contingencies
H. Segments and Lines of Business
I. Employee Benefits
J. Analysis of Financial Statements
K. Development Stage Enterprises
L. Personal Financial Statements
M. Combined Financial Statements

VII. Cost Accumulation, Planning, and Control (10 percent)

A. Nature of Cost Elements

1. Direct Materials
2. Direct Labor
3. Overhead

B. Process and Job Order Costing
C. Standard Costing
D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
E. Absorption and Variable Costing
F. Budgeting and Flexible Budgeting
G. Breakeven and Cost-Volume-Profit Analysis
H. Capital Budgeting Techniques

1. Net Present Value
2. Internal Rate of Return
3. Payback Period
4. Accounting Rate of Return

I. Performance Analysis

1. Return on Investment
2. Residual Income
3. Controllable Revenue and Costs

J. Other

1. Regression and Correlation Analysis
2. Economic Order Quantity
3. Probability Analysis
4. Variance Analysis
5. Differential Cost Analysis
6. Product Pricing

VIII. Not-for-Profit and Governmental Accounting (10 percent)

A. Conceptual Framework
B. Fund Accounting

1. Fund Balance
2. Estimated Revenues
3. Appropriations
4. Encumbrances
5. Fund Balance Reserved for Encumbrances
6. Revenues
7. Expenditures

C. Types of Funds and Account Groups

1. General Fund
2. Special Revenue Funds
3. Debt Service Funds
4. Capital Projects Funds
5. Enterprise Funds
6. Internal Service Funds
7. Trust and Agency Funds
8. General Fixed Assets Account Group
9. General Long-Term Debt Account Group
10. Endowment and Quasi-Endowment Funds
11. Restricted and Unrestricted Funds
12. Property Funds

D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations
E. Various Types of Not-for-Profit and Governmental Organizations

1. Local and State Governments
2. Educational Institutions
3. Hospitals
4. Charitable, Religious, and Other Organizations

Auditing Section

The Auditing section tests the candidates' knowledge of generally accepted auditing standards and procedures. The section includes professional responsibilities, internal control, evidence and procedures, and reporting.

In preparing for this section, candidates should study publications such as the following:

- AICPA Code of Professional Conduct
- Statements on Auditing Standards
- U.S. General Accounting Office Government Auditing Standards

- Statements on Standards for Accounting and Review Services
- Statements on Quality Control Standards
- Statements on Management Advisory Services
- Statements on Responsibilities in Tax Practice
- Statements on Standards for Attestation Engagements
- Statement on Standards for Accountants' Services on Prospective Financial Statements
- AICPA Audit and Accounting Guides
- Auditing textbooks

Auditing—Content Specification Outline

I. Professional Responsibilities (15 percent)

A. General Standards and Code of Professional Conduct

1. Proficiency, Independence, and Due Care
2. Code of Professional Conduct

B. Control of the Audit

1. Planning and Supervision
2. Audit Risk and Materiality
3. Analytical Procedures
4. Quality Control

C. Other Responsibilities

1. Detecting and Reporting Errors and Irregularities
2. Illegal Acts by Clients
3. Responsibilities in Review and Compilation
4. Responsibilities in Attestation Engagements
5. Responsibilities in Management Advisory Services
6. Responsibilities in Tax Practice

II. Internal Control (30 percent)

A. Definitions and Basic Concepts
B. Consideration of the Internal Control Structure
C. Cycles

1. Sales, Receivables, and Cash Receipts
2. Purchases, Payables, and Cash Disbursements
3. Inventories and Production
4. Personnel and Payroll
5. Financing and Investing

D. Other Considerations

1. Communication of Internal Control Structure Related Matters
2. Reports on Internal Control
3. Sampling
4. Flowcharting

III. Evidence and Procedures (30 percent)

A. Audit Evidence

1. Nature, Competence, and Sufficiency of Evidential Matter
2. Evidential Matter for Financial Statement Assertions
3. Analytical Procedures
4. Client Representations

5. Using the Work of a Specialist
6. Inquiry of a Client's Lawyer

B. Specific Audit Objectives and Procedures

1. Tests of Details of Transactions and Balances
2. Documentation

C. Other Specific Audit Topics

1. Use of the Computer in Performing the Audit
2. Use of Statistical Sampling in Performing the Audit
3. Related Party Transactions
4. Subsequent Events
5. Compliance Auditing
6. Omitted Procedures Discovered After the Report Date

D. Review and Compilation Procedures

1. Understanding of Accounting Principles and Practices of the Industry
2. Inquiry and Analytical Procedures
3. Unusual Matters
4. Other Procedures

IV. Reporting (25 percent)

A. Reporting Standards and Types of Reports

1. Unqualified
2. Explanatory Language Added to the Standard Report
3. Qualified
4. Adverse
5. Disclaimer
6. Consistency
7. Going Concern
8. Reporting Responsibilities
9. Comparative
10. Scope of Examination
11. Generally Accepted Accounting Principles
12. Disclosure
13. Review and Compilation
14. Review of Interim Financial Information
15. Special Reports
16. Negative Assurance
17. Prospective Financial Statements
18. Compliance With Laws and Regulations

B. Other Reporting Considerations

1. Subsequent Discovery of Facts Existing at the Date of the Auditor's Report
2. Dating of the Auditor's Report
3. Part of Examination Made by Other Independent Auditors
4. Letters for Underwriters
5. Filing Under Federal Securities Statutes
6. Other Information in Documents Containing Audited Financial Statements
7. Required Supplementary Information
8. Information Accompanying the Basic Financial Statements
9. Communication With Audit Committees

Business Law Section

The Business Law section tests the candidates' knowledge of the legal implications of business transactions, particularly as they relate to accounting and auditing. The section includes the CPA and the law, business organizations, contracts, debtor-creditor relationships, government regulation of business, Uniform Commercial Code, and property. The subjects on the examination normally are covered in standard textbooks on business law, auditing, taxation, and accounting. Candidates are expected to recognize the existence of legal implications and applicable basic legal principles, and they are usually asked to indicate the probable result of the application of such basic principles.

The Business Law section is chiefly conceptual in nature and is broad in scope. It is not intended to test competence to practice law or expertise in legal matters, but to determine that the candidates' knowledge is sufficient (1) to recognize relevant legal issues, (2) to recognize the legal implications of business situations, (3) to apply the underlying principles of law to accounting and auditing situations, and (4) to seek legal counsel or recommend that it be sought.

This section deals with federal and widely adopted uniform laws. Where there is no federal or appropriate uniform law on a subject, the questions are intended to test knowledge of the majority rules. Federal tax elements may be covered where appropriate in the overall context of a question.

Business Law—Content Specification Outline

I. The CPA and the Law (10 percent)

A. Common Law Liability to Clients and Third Persons

B. Federal Statutory Liability

1. Securities Acts
2. Internal Revenue Code

C. Workpapers, Privileged Communication, and Confidentiality

II. Business Organizations (20 percent)

A. Agency

1. Formation and Termination
2. Liabilities of Principal
3. Disclosed and Undisclosed Principals
4. Agent's Authority and Liability

B. Partnerships and Joint Ventures

1. Formation and Existence
2. Liabilities and Authority of Partners and Joint Owners
3. Allocation of Profit or Loss
4. Transfer of Interest
5. Termination, Winding Up, and Dissolution

C. Corporations

1. Formation, Purposes, and Powers
2. Stockholders, Directors, and Officers
3. Financial Structure, Capital, and Dividends
4. Merger, Consolidation, and Dissolution

D. Estates and Trusts

1. Formation and Purposes
2. Allocation Between Principal and Income
3. Fiduciary Responsibilities
4. Distributions and Termination

III. Contracts (15 percent)

A. Offer and Acceptance
B. Consideration
C. Capacity, Legality, and Public Policy
D. Statute of Frauds
E. Statute of Limitations
F. Fraud, Duress, and Undue Influence
G. Mistake and Misrepresentation
H. Parol Evidence Rule
I. Third Party Rights
J. Assignments
K. Discharge, Breach, and Remedies

IV. Debtor-Creditor Relationships (10 percent)

A. Suretyship

1. Liabilities and Defenses
2. Release of Parties
3. Remedies of Parties

B. Bankruptcy

1. Voluntary and Involuntary Bankruptcy
2. Effects of Bankruptcy on Debtor and Creditors
3. Reorganizations

V. Government Regulation of Business (10 percent)

A. Regulation of Employment

1. Federal Insurance Contributions Act
2. Federal Unemployment Tax Act
3. Worker's Compensation Acts

B. Federal Securities Acts

1. Securities Registration
2. Reporting Requirements
3. Exempt Securities and Transactions

VI. Uniform Commercial Code (25 percent)

A. Commercial Paper

1. Types of Negotiable Instruments
2. Requisites for Negotiability
3. Transfer and Negotiation
4. Holders and Holders in Due Course
5. Liabilities, Defenses, and Rights
6. Discharge

B. Documents of Title and Investment Securities

1. Warehouse Receipts
2. Bills of Lading
3. Issuance, Transfer, and Registration of Securities

C. Sales

1. Contracts Covering Goods
2. Warranties

3. Product Liability
4. Risk of Loss
5. Performance and Obligations
6. Remedies and Defenses

D. Secured Transactions

1. Attachment of Security Interests
2. Perfection of Security Interests
3. Priorities
4. Rights of Debtors, Creditors, and Third Parties

VII. Property (10 percent)

A. Real and Personal Property

1. Distinctions Between Realty and Personalty
2. Types of Ownership
3. Lessor-Lessee
4. Deeds, Recording, Title Defects, and Title Insurance

B. Mortgages

1. Characteristics
2. Recording Requirements
3. Priorities
4. Foreclosure

C. Fire and Casualty Insurance

1. Coinsurance
2. Multiple Insurance Coverage
3. Insurable Interest

Accounting Practice

Accounting Theory

Auditing

Business Law

November 1992 Uniform CPA Examination

Content Specification Outlines

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